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THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

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The Canadian Chartered Accountant

VOLUME 55 OCTOBER 1949 NUMBER 4

COMMENT AND OPINION

The Noronic Disaster

FROM all accounts received, members of our Association were of considerable assistance in the sad circumstances surrounding the fire on the S.S. Noronic at Toronto during the night of Friday, September 16.

The disaster occurred at the climax of the final banquet and dance of the Annual meeting and the majority of our Toronto members had returned to their homes. Those still at the Royal York Hotel, many of them from other Provinces or parts of Ontario, immediately offered their services in various ways, such as making suites and bedrooms available, caring for and assisting survivors, operating with their cars a shuttle service from the steamer to the hotel and in a host of other ways. Many continued at their self-appointed tasks until late in the day of Saturday. To all concerned, and we do not forget their wives, we extend our compliments and thanks on behalf of the city of Toronto.

To our friends in the United States, we extend our sincere sympathy in the tragedy which befell Canada's guests on a Canadian ship at a Canadian port.

Fund Accounting

TWO articles in *The Journal of Accountancy,* August 1949, are recommended reading for our many members whose duties include the audit of non-profit institutions and who have an interest in fund accounting. Under the titles "Something Is Wrong with College Financial Reports" and "Reasons Why University Accounting Must Differ from Conventional Commercial Accounting", Ernest W. Baldassare and Ira B. McGladney, respectively, discuss their separate points of view. While they refer particularly to institutions for higher education, in many respects their comments are equally applicable to hospitals, research foundations, etc., dependent upon the earnings and use of endowments, an important part of which are invested in capital assets. Both articles stress the fundamentals of fund accounting and the importance of keeping the accounting for any one fund completely separate and distinct from that of any other fund. As Mr. Baldassare says, "Fund accounting is a specialized field of accountancy, used for recording the transactions of non-profit organizations such as governmental authorities, educational institutions, hospitals and other eleemosynary institutions. The greatest difference between university accounts and those of commercial enterprises is the fact that universities have no *proprietorship* or *capital* accounts as such (representing equity of the owners). Instead, the university is held *accountable* for the various funds which have been donated or bequeathed to it. *The principal of each fund, therefore, is set up as the equivalent of a 'capital' account, on the credit*

side of the ledger, and represents the difference between the assets of the fund (cash and/or investments) and its liabilities."

We have found these articles most interesting and instructive. We would welcome submissions from our members on prevailing practices in Canada in this field.

Simplified Accounts

THE following interesting paragraph is taken from *The Accountant* (the journal of The Institute of Chartered Accountants in England and Wales). Sir Frederick Alban is immediate past president of The Society of Incorporated Accountants.

> It has been interesting to note the reaction of the "erudite financial editors" to Sir Frederick Alban's suggestion at the Society's annual meeting that company accounts under the new Act are becoming too complicated for the layman. The Financial Times tended to agree and followed up Sir Frederick's idea of separate simplified accounts for the unlearned with an inquiry as to the possibility of providing with the report "a simplified but accurate guide to the main figures". The City Editor of The Times was more cautious. Apart from other considerations, he saw a "more fundamental danger" in the possibility that financial reporting for the layman might become a mere appendage of "public relations", with "all that this sometimes implied, instead of the responsibility of the accountant". In this column, we have supported any move to get the facts across to shareholders. We are not so certain, however, that some of the diagrams we have seen, such as pictures of pound notes cut into portions to show the dissection of turnover, are worth while. We like plain figures and plain words to explain them. They can present the main accounts in simplified form. They can describe the ebb and flow of business conditions and results. After all, however, is it possible that too pessimistic a view is being taken of the layman's mental capacity?

The Annual Meeting

THE annual meeting well fulfilled the hopes and expectations we held out for it last month. The contribution to the profession made by our members and our guests, including those who were asked to tell us about ourselves and what our place in business should be, was outstanding. Our special guests, Mr. B. H. Binder, immediate past president, The Institute of Chartered Accountants in England and Wales, Mr. P. F. Brundage, president, The American Institute of Accountants and Mr. Carman G. Blough, director of research, The American Institute of Accountants, were at once learned and capable speakers and very good company. We are greatly indebted to them for their part in the proceedings. A more detailed account of the meeting appears elsewhere in this issue with some of the addresses which were received with great interest. Others will follow in subsequent issues.

Income Tax In Britain and Canada

WE are pleased to be able to publish in this issue two of the three addresses on income tax delivered at the annual meeting. Mr. Binder's paper is a *tour de force* in masterly compression, and Mr. Gavsie's, another excellent effort, offers to the discerning a glimpse behind the scenes, unless Mr. Abbott's first budget address to the 21st Parliament comes before this number sees the light of day. Mr. Brundage's most able review of the U.S. position on the income taxation of business must, of necessity and with regret, await the November issue.

Mr. H. R. Doane, C.A.
President of the Dominion Association of Chartered Accountants, 1949-50

Mr. B. H. Binder, F.C.A.

Immediate Past President, Institute of Chartered Accountants in England and Wales

Mr. E. J. Howson, F.C.A.

Immediate Past President, The Dominion Association of Chartered Accountants

Mr. P. F. Brundage

President, The American Institute of Accountants

Income Taxation in the United Kingdom

By B. H. Binder, F.C.A.
(Immediate Past President, Institute of Chartered Accountants in England and Wales)

An outline of the British income tax on several vital topics

INTRODUCTION

THE old adage: "A little learning is a dangerous thing" can be applied to income tax with as much force as to any other subject. Many books and papers have been written to expound and explain the laws enacted by Parliament and their interpretation by legal decisions which govern the assessment of income tax in the United Kingdom. Therefore, in responding to the request to read to this assembly a paper on British income tax as it affects corporate bodies and certain individuals, I trust it will be appreciated that this paper is not comprehensive as, in the short time I had available to prepare it and in the limited time allocated for it to be read, I cannot hope to deal exhaustively with the subject but can only stress certain aspects and deal, in a general way, with some of the intricacies of assessment.

The land tax first imposed in 1692 may be regarded as the earliest income tax in England as it included a tax on the yearly value of personal assets as well. Over the years further income tax Acts were imposed and repealed. In particular by an Act of 1909 super-tax was added, now however called sur-tax. In 1918 a Consolidated Act was passed and this, as modified by annual Finance Acts, the regulations made thereunder and various decisions of the Courts, establishes the basis on which income tax is now assessed in the United Kingdom. Furthermore, in 1937, an additional tax on business profits was authorized, which has been subsequently amended and is now known as profits tax. This tax is not levied on the profits of individuals.

Rates of Taxes

The present rates of taxes are as follows:—

1. Income Tax at a standard rate of 9/– in the £. All taxable income is charged at this rate, subject to certain reliefs to individuals.

2. Sur-tax on a sliding scale in respect of total annual incomes of individuals in excess of £2,000; the rates range from 2/– in the £ to 10/6d in the £, the latter rate being levied on the excess of all incomes over £20,000, thus bringing up the total tax on incomes over that figure to 19/6d in the £.

3. Profits tax is at a basic rate of 25% on the profits of companies. This basic

A paper read at the 47th annual meeting of the D.A.C.A., Toronto, Sept. 15

rate of 25% is subject to a reduction to 10% on profits not distributed; a rebate is also allowed in respects of annual profits below £12,000; annual profits of £2,000 and under are exempt. Special arrangements however apply to building and other societies.

I. COMPUTATION OF ASSESSABLE PROFITS AND THE TAX THEREON

The remarks under this heading relate mainly but not exclusively to the taxation of limited liability companies carrying on a trade or business. Certain corporate bodies have special arrangements applicable to the taxation of their profits.

A company is a separate legal entity and is taxed at the full standard rate of income tax on its profits. In computing taxable profits short term interest and annual interest on secured loans payable to non-residents are deductible, but other annual interest and royalties are not deductible. The company, however, is entitled to deduct income tax on those items when paying them and to retain such tax. It also has the right to deduct and retain tax from any dividends which it may distribute to its shareholders. This is an illustration of the general principle of taxing income at the source. Some companies pay what is described as a "tax free dividend". This description is a misnomer. A tax free dividend is a dividend paid at a specified rate without specific deduction of income tax. In law the amount distributed is equivalent to a dividend at a higher rate less the tax in force. For example, a tax free dividend of 5½% on £100 would be £5 10 0

This is equivalent to a gross dividend of 10% £10 0 0		
Less: *income tax* at the standard rate of 9/– in the £	4 10 0	
Net amount		£5 10 0

Where a company pays interest on debentures or loans from a source other than profits or gains on which income tax is payable, the tax deducted therefrom is charged by separate assessment on the company which has in effect collected such tax on behalf of the Inland Revenue.

Trading Profits

The Acts give no general rules for the ascertainment of trading profits. Such profits are normally assessed under the Rules of Case 1, Schedule D, *Income Tax Act 1918* as amended by subsequent Acts. Rule 1 of those Rules provides that the tax "shall be computed on the full amount of the balance of the profits or gains". Rule 3 sets out various items which shall not be deducted in arriving at the profits assessable to tax. In particular Rule 3 specifies that nothing shall be deducted in respect of "expenditure not wholly and exclusively laid out for the purposes of the trade".

It has been left largely to the Courts to interpret the meaning of the phrase "balance of the profits or gains". Lord Macnaghten in *London County Council* v. *Att'y. Gen'l* stated: "Income tax, if I may be pardoned for saying so, is a tax on income. It is not meant to be a tax on anything else." It is a general principle that profits on the realisation of capital assets as distinct from current assets are not taxable. This position however has been affected by the *Income Tax Act 1945* which taxes certain capital profits arising on the sale of patents. Whether assets are capital assets or not depends on the purpose for which they are held. For example a company

owning landed property for the purpose of deriving income from rents or from farming operations would not be charged income tax on any profit made on the sale of all or part of its property, but a company carrying on a business of buying and selling land and buildings would be liable for tax on profits derived therefrom. An investment trust company which acquires investments with the main object of deriving income therefrom in the form of interest and dividends would not be taxable on any profits realised on the sale of its investments, nor, on the other hand, would it be allowed as a charge against its profits any losses on realisation of investments. But a finance company, whose main object is dealing in investments, would be taxed on its profits less losses arising from such dealings.

There have been many decisions in the Courts as to what receipts are or are not to be included or what expenditure is or is not allowable in computing profits for assessment. They emphasize that circumstances alter cases.

Trading losses in any year computed for income tax and profits tax purposes may be set off against assessments of future trading profits but with a time limit of six years in respect of income tax subject to extension in respect of the war period. There is no time limit to that part of the losses which represent depreciation allowances.

Mr. B. H. Binder, F.C.A., senior partner of Binder, Hamlyn & Co., Chartered Accountants, London, England, was admitted to the Institute of Chartered Accountants in England and Wales in 1908. He was elected president of that Institute for the term 1948-49. Engaged on several occasions in British Government work, Mr. Binder was attached to the Government mission to Argentina in 1946. He is also chairman of Inveresk Paper Co. Ltd., British Shareholders Trust Ltd., and Central Wagon Co. Ltd.

For tax purposes, depreciation as charged in a profit and loss account is disregarded. Instead, allowances are granted on certain assets on a basis provided for in the Acts and these allowances may differ widely from what might be regarded by the directors of a company as a proper charge in the accounts for depreciation. Owing to the importance of depreciation allowances I propose to refer to them in more detail.

II. DEPRECIATION ALLOWANCES

Allowances for depreciation have become of even greater importance now that the cost of replacements has so largely increased. The British government has made a partial recognition of the financial burden which this factor imposes by granting larger 'initial' allowances on capital expenditure. These initial allowances, however, only result in temporary relief as what is additionally allowed in the first year is adjusted in the subsequent annual allowances spread over the life of the asset.

The initial allowances may be, and in the larger number of cases are, far greater than the normal annual allowances or the ordinary commercial rate of depreciation. Their effects in reducing the profits tax and income tax payable and, if charged in the accounts, in reducing the profits for the year in which they are granted are outside the scope of this paper. I may, however, mention that in a number of cases adjustments are made in accounts to level out these effects.

Prior to the *Finance Act 1944* and *Income Tax Act 1945* annual allowances for depreciation of fixed assets were limited to mills and factories and plant and machinery, the allowances in respect of the latter being commonly known as wear and tear allowances.

The Acts of 1944 and 1945 considerably extended the allowances which may be broadly summarised as follows:—

(a) *Industrial Buildings or Structures*

This new nomenclature which has been adopted has a more extensive meaning than the expression "mills and factories".

The allowances on these assets are based on a presumed life of 50 years and are calculated on the cost of construction other than the cost of the site and its preparation. Subsequent alterations or additions are treated as though the expenditure thereon was in respect of separate buildings or structures.

There is an initial allowance at the rate of 10% on the cost of industrial buildings, etc., constructed after April 5, 1944 and also from April 6, 1946 an annual allowance at the rate of 2% on the straight line basis.

As regards older buildings and structures, only the annual allowance of 2% applies and this is calculated on the balance of the cost proportionate to the unexpired period of a presumed life of 50 years.

When a building or structure less than 50 years old is sold, destroyed or permanently put out of use, a balancing allowance is given or a balancing charge is levied in order to equate the total allowances given, or deemed to have been given, to the difference between the original cost and the proceeds of sale, etc. The balancing allowance is given to cover a loss on the original cost reduced by previous allowances; the balancing charge is made to the extent to which allowances already given are recovered on a sale. Any excess of sale proceeds, etc. over original cost is a capital profit and is not taxable. A buyer of a building is granted annual allowances to amortise the purchase price (subject to the limit of original cost of construction) over the residue of a presumed life of 50 years.

Industrial buildings are defined in the Act. Broadly speaking, the term includes what would generally be regarded as buildings used for industry, including buildings provided for the welfare of workers but excluding dwelling houses, retail shops, showrooms, hotels and also offices under certain conditions. The term "industrial structure" covers works such as walls, bridges, dams, roads, etc. but does not include the cost of preparing a site.

The present allowances replace the special allowances for depreciation of mills, factories and other similar premises given previously and which in certain cases are more advantageous to the tax payer, who may elect to continue on the old basis until the 5th April 1951.

(b) *Machinery and Plant*

As from the 6th April 1944 allowances for machinery or plant are generally based on an initial allowance on its cost and an annual allowance (commonly termed wear and tear) while it is in use. When machinery or plant is sold, scrapped or destroyed, a balancing allowance is given or a balancing charge is made in order to equate the total allowances, as explained in regard to buildings. Any excess of sale proceeds over original cost is not taxable.

The initial allowance originated as from the 6th April 1944 at the rate of 20% and was increased to 40% from the 6th April 1949 in respect of expenditure on and after that date.

As regards the annual allowances, rates of wear and tear on a percentage basis have been agreed with the Inland Revenue in respect of most classes of machinery or plant. These agreed rates

increased by one quarter are allowed. Any alterations in these rates would not normally be considered by the Inland Revenue unless representations were made on behalf of a representative group of any particular trade or business.

The usual method of computing annual wear and tear is what is termed the reducing balance method. In other words in ascertaining the wear and tear for any year the agreed percentage is calculated on original cost progressively reduced by each allowance. In some cases, particularly ships and commercial aircraft, the straight line method is adopted, that is the annual allowance is calculated at a percentage of the original cost. This latter method can now, by arrangement with the Inland Revenue, in accordance with the terms of the *Finance Act 1949,* be extended to any machinery or plant, but the percentages are subject to negotiation.

Another basis, which however is not widely adopted except in respect of tools and hotel equipment, is known as the renewals basis. Initial and annual allowances are not given but, when replacements are effected, the cost of replacement less any proceeds realised on sale, excluding any amounts representing improvements, is allowed as a deduction. In the absence of replacement, no allowance is given.

(c) *Mines, Oil Wells, etc.*

Allowances are given in respect of capital expenditure incurred in connection with a mine, oil well and other source of mineral deposits of a wasting nature and, in searching for and discovering and testing deposits or winning access thereto, or on the construction of any works which are likely to be of little or no value when the source is no longer worked.

Under the *Income Tax Act of 1945* by which the allowances are granted no allowance is given in respect of any expenditure incurred on the acquisition of rights in or over the deposits. The *Finance Act 1949* now gives an allowance in respect of such expenditure outside the United Kingdom under certain conditions after the 5th April 1949.

The allowances comprise an initial allowance of 1/10th of a part of such expenditure and also annual allowances based on the annual output from the source proportionate to the estimated future total output computed on the reducing balance method. They do not apply to such items as plant or machinery, which receive allowances on the general basis already explained.

In the event of a sale a balancing allowance is given or a balancing charge is made as may be required. Any excess of sale proceeds over original cost is not taxable.

(d) *New Farm Buildings*

Where the owner or tenant of any agricultural or forestry land incurs capital expenditure after the 6th April 1944 on the construction of farm houses, farm or forestry buildings, cottages, fences or other works for the purposes of husbandry or forestry, an annual allowance is granted of 1/10th of the expenditure, thus writing off the expenditure in ten years.

Where expenditure is incurred partly for the purposes of husbandry or forestry and partly for other purposes, an apportionment is made.

The allowance is continued to a successor in ownership or tenancy.

(e) *Patents*

Capital expenditure after the 5th April 1946 on the purchase of patent rights is allowed to be written off by equal annual instalments over seventeen years or a shorter period representing the remaining life of the patent or the period for which the rights were purchased. This allowance is limited to cases where the patent rights have not been sold or licensed for a capital sum before the 6th

April 1946.

When the rights acquired are sold a balancing allowance or balancing charge is made as may be required.

Any profit on a sale of a patent not sold or licensed before the 6th April 1946, which was previously regarded as a capital profit, is now assessable as income. Where the seller is resident in the United Kingdom the assessment is spread over six years, but he has the option to have the whole assessment made in the year of sale. For a seller not resident in the United Kingdom the position as regards assessment is reversed.

(f) *Scientific Research*

Capital expenditure incurred after the 6th April 1946 on scientific research relating to a trade or business is allowable for income tax purposes by five equal annual instalments. The balance of certain capital expenditures incurred before the 6th April 1946 is given similar allowances. For capital expenditure after the 6th April 1949 the allowances are three-fifths in the first year and one-tenth in each of the four subsequent years.

Current revenue expenditure is allowable as a deduction in computing profits for income tax purposes.

Research expenditure by a trader is only allowable if it is in relation to his trade.

III. PROFITS TAX

The basic rate of profits tax is 25%[1] reducible to 10% on undistributed profits. This tax is limited to 10% on foreign companies carrying on business in the United Kingdom and on dividends paid to a foreign company by its British subsidiary.

For profits tax purposes, profits are in general ascertained on income tax principles, but subject to certain differences specified in the Acts. For instance, interest on debentures is allowed as a deduction in arriving at the profits assessable. Unlike income tax a company cannot recoup itself for the profits tax it pays by passing any part of it on to its shareholders by deduction from dividends. As the higher rate of 25% is payable on profits distributed as dividends to holders of both preference and ordinary shares, in effect the ordinary shareholders bear the whole burden of the tax.

Holding companies have the option to group their profits with the profits of all or any of such of their subsidiaries as are liable to profits tax.

Profits tax payable is allowed as an expense for the purpose of arriving at profits assessable to income tax.

Tax on Undistributed Profits

Whilst there is no tax in the United Kingdom on undistributed profits as such, undistributed profits affect the tax position of a company in respect of profits tax and sur-tax. The reduction in the rate of profits tax from 25% to 10% on undistributed profits has already been mentioned.

Sur-tax which is levied only on the income of individuals is, however, chargeable on the undistributed income of certain companies in the following circumstances:

The income of a company controlled by not more than five persons or families and which does not distribute within a reasonable time a reasonable part of the income of any accounting period may be treated as the income of the members and notionally apportioned among such members on the basis of their individual in-

[1] In the last week of September, 1949, Sir Stafford Cripps announced an increase to 30% in profits tax.—ED.

terests in the company, and such apportionments are regarded as the income of the members for purposes of sur-tax. If the individual members do not meet the sur-tax appropriate to each of them the company is charged with the tax. The company has no legal right to recover from the members concerned, so that sur-tax paid by the company becomes a charge on all the shareholders even though some may not be liable to sur-tax.

In the case of investment companies similarly controlled, the whole of the investment income is automatically apportioned among the members for sur-tax purposes.

The Acts contain elaborate provisions defining the question of control.

These provisions do not apply to any company in which the public is interested in the voting share capital, other than preference shares, to the extent of 25% and such share capital is the subject of dealings on a stock exchange, nor to a company which is a subsidiary of another company to which the provisions do not apply.

In determining whether a company has or has not distributed a reasonable part of its income, regard must be had to the current requirements of its business and to such other requirements as may be necessary or advisable for the maintenance and development of that business.

Limitation of Dividends

Over the past year or so there has been in existence a voluntary arrangement between the government and industry for the limitation of dividends. In view of this arrangement reassurances were sought on behalf of companies falling within the sur-tax provisions. An assurance has been given by the government to the effect that no action under the sur-tax provisions will be taken against an industrial or trading company in a bona fide case where the rate of dividend is the same as that which was accepted as reasonable in previous periods even though profits may have increased. Furthermore, if for special reasons no dividend at all was declared in the period before June 1947 and action was not taken under the sur-tax provisions, the Inland Revenue will not under present circumstances challenge the continuance of this policy in bona fide cases.

Profits tax is not levied on a company in a year when its profits are apportioned to individuals for sur-tax purposes.

Period on Which Assessment is Based

For a long time the assessment of income tax on the profits of trades and businesses for the government's fiscal year ending on April 5 was based on the average of the three preceding years of account, but since 1926 it has been based on the profits of the immediately preceding year of account, with the exception of new and discontinued businesses where special rules prevail for the early and closing years. Profits tax, however, is levied on the profits of each accounting period without relation to the government's fiscal year.

The basic period to be taken in assessing income tax on profits is one of the terms of reference of the Committee recently set up by the Chancellor of the Exchequer, referred to later.

IV. VALUATION OF TRADING STOCKS

The usual method of valuing trading stocks for general accountancy purposes and for taxation is cost or market price, whichever is the lower, with due provision for damaged, redundant or obsolete items. In practice this method is generally applied to each separate item of trading stock.

The taxing Acts contain no rules as to the valuation of trading stocks except

in isolated cases relating to certain losses on stocks which might be claimed for the purposes of excess profits tax, which has now come to an end. In those cases it was provided that stocks should be valued wholly at cost or wholly at market price and that the lower of these two methods should be adopted. The Inland Revenue have recently made some endeavour to apply the E.P.T. basis for income tax purposes but this is being strenuously resisted in various quarters.

In certain businesses such as tea, rubber and mining, it is customary, and admitted for taxation purposes, to value trading stocks at the end of an accounting period at the price subsequently realised, less selling costs.

In ascertaining the cost of work in progress the Inland Revenue usually endeavour to include some element of overheads. This is a controversial point and there is no generally accepted basis with regard to overheads, but it is rightly insisted that there should be a continuity in whatever method is adopted.

V. TAXATION OF NON-RESIDENTS AND FOREIGN COMPANIES

The United Kingdom income tax laws do not in general differentiate between British subjects and other nationalities but only as to domicile and as to residents and non-residents. Non-residents must pay tax on income derived from the United Kingdom, except in respect of the interest on certain British government securities issued with special exemption, and are not entitled to any personal reliefs unless they are British subjects or fall within certain very limited categories.

Companies incorporated outside the United Kingdom which are managed and controlled in the United Kingdom are deemed to be resident and are taxable on the same basis as British companies carrying on business in the United Kingdom.

The liability of a non-resident individual or company to taxation on profits arising from business transactions in the United Kingdom depends upon whether he or it can be held to be carrying on business within the United Kingdom or only carrying on business with the United Kingdom. This depends upon the facts of each case. An important factor is whether or not contracts for the sale of goods or performance of services are made in the United Kingdom, but the fact that contracts are made outside the United Kingdom does not always exempt their resulting profits from taxation.

Without going into this question in more detail it is not possible to draw the line between transactions which are taxable and those which are non-taxable.

If the amount of the profits of any non-resident chargeable with tax cannot readily be ascertained, the Inland Revenue may assess the profits on a percentage basis, in regard to which there is a right of appeal if the percentage fixed by the authorities is regarded by the taxpayer as too high.

A person domiciled or ordinarily resident out of the United Kingdom may nevertheless become technically resident in the country for tax purposes. Residence is a question of fact. Domicile is largely a legal concept.

A distinction is made between "ordinarily resident" and "resident" which is important for tax purposes. This distinction has been discussed in a number of cases before the Courts and gives rise to differences in assessments regarding income derived from abroad.

Double Taxation

Companies carrying on business in the United Kingdom and in other countries, whether incorporated in the United Kingdom or not, obtain relief from dou-

ble taxation on their profits in those countries between whom double taxation conventions have been entered into. As such conventions have been made between the United Kingdom and Canada and the United Kingdom and the United States, Canadian and American companies obtain the relief provided for by the conventions.

In the case of income or profits arising in any British Dominion with which there is no double taxation agreement, relief is allowed against United Kingdom tax on doubly taxed profits at the lower of the Dominion rate or half the United Kingdom rate.

Where neither of the foregoing circumstances apply, foreign taxes are allowed as an expense in computing profits liable to taxation.

VI. EXPENSES INCURRED AS A CONDITION OF EMPLOYMENT

The remuneration of employed persons is assessed for income tax under what is known as Schedule E of the *Income Tax Act 1918,* as amended by later Acts, whereas trading profits are assessed under Schedule D on the basis already outlined.

Taxation under Schedule E is based on the actual earnings and under P.A.Y.E. (i.e. Pay-as-you-earn) is deducted from the earnings as and when they are paid. Employed persons are entitled to the full personal reliefs set out in the Acts. They are also entitled to claim for expenses but only within the terms of the provisions of Schedule E which are more restricted in scope than the provisions of Schedule D under which trading profits are assessed.

Rule 9 of Schedule E provides that a deduction may be claimed in respect of expenses "wholly exclusively and necessarily incurred in the performance of the duties". These words have proved a stumbling block in the way of prospective claimants. For example, they preclude an allowance for travelling expenses of an employee between his home and his regular place of business, which a layman might reasonably assume are in certain cases incurred to earn the remuneration.

Disallowance of travelling expenses has now been tightened up to the extent that a director of various companies who has to attend board meetings at their offices, which may be widely scattered, involving in some cases both rail and hotel expenses, is not allowed to deduct those expenses from his remuneration for purposes of assessment to tax.

The treatment of subscriptions to professional societies varies with circumstances. A member of a recognized accountancy body such as the Institute of Chartered Accountants who is employed on condition that he is and remains a member of that Institute would be entitled to claim as an expense his annual subscription to the Institute. Where, however, this condition is not essential to the continuance of such appointment a claim would not strictly speaking be admissible, but on the grounds of *de minimis*[2] might be allowed.

Two Leading Cases

There are two tax cases which are of interest in this connection: a county medical officer claimed a deduction in respect of his subscriptions to certain medical societies. Persons in his position were usually members of such societies but membership was not a condition of employment. The claim was refused. A later case related to a divisional engineer of the London County Council who claimed relief in respect of his annual subscription to the Institute of Civil En-

[2]*De minimis non curat lex* — The law will not concern itself with matters of little or no consequence. — ED.

gineers. Candidates for such an appointment were required to be members of that Institute or hold some other approved qualification, but it was not specifically a condition that membership should be continued after appointment. The claim was refused.

Unless therefore it can be shown that the tenure of employment is dependent on the retention of membership of a specified society a claim for relief in respect of contributions to the society would in all likelihood be refused.

Sometimes officials or employees of a business are expected to bear all or part of the cost of travelling and entertainment expenses. In these instances a claim for relief would be granted on the facts being proved.

As a result of various decisions in the Courts the following general principles have been established:

(1) The expenses must necessarily attach to the office or appointment.

(2) They must be incurred in the actual performance of the duties.

(3) They must be wholly and exclusively so incurred.

There are two other points which might be noted: contributions by employees as well as employers to superannuation schemes approved by the Inland Revenue are eligible for relief. Such contributions are often a condition of employment. Contributions paid under the *National Insurance Act* are also allowed.

VII. APPEALS AGAINST TAX ASSESSMENTS

A tax payer is entitled to appeal against any assessment made upon him for income tax, sur-tax or profits tax. An appeal is normally made either to the General Commissioners or Special Commissioners who are appointed for the particular purpose of hearing such appeals and also assist in making assessments. A Commissioner who has acted in connection with an assessment cannot take any part in deciding an appeal.

Sur-tax appeals are dealt with only by the Special Commissioners.

Many years ago legislation was passed providing for the election of Land Tax Commissioners. These Commissioners appoint the General Commissioners who have power to appoint new Commissioners from a list of suitable persons. They are a part-time body acting in an honorary capacity. Their functions are local in character. A body of General Commissioners is set up for each unit of area into which the United Kingdom is divided for their special duties of hearing appeals. They usually consist of local business and professional men and land owners and have a practical knowledge of local conditions. They are assisted by a clerk who is generally a solicitor or barrister.

Special Commissioners are appointed by the Treasury and in contrast to the General Commissioners they act in a full-time capacity and are paid for their services. Special Commissioners do not deal with any particular area but go on circuit to hear appeals. They generally possess legal qualifications and a wide knowledge of taxation laws.

Both the General Commissioners and the Special Commissioners act independently of the Inland Revenue and are regarded as a protection of the taxpayers' interests.

A tax payer may elect to have an appeal heard by the General Commissioners or Special Commissioners in certain instances and it is often a matter for some consideration whether an appeal should be made to the General Commissioners or the Special Commissioners. In some

cases an appeal can be made only to the General Commissioners and in other cases only to the Special Commissioners. The status of these two bodies of Commissioners in hearing appeals is equal and there is no appeal from the General Commissioners to the Special Commissioners or vice versa. The appellant can be represented by a barrister or solicitor or an accountant but for this purpose an accountant must be a member of a recognized body of accountants. The tax official may also attend an appeal and is entitled to be represented by a barrister or solicitor and to have the services of the Legal Department of the Inland Revenue.

The proceedings are held in private and the appellant may be examined on oath administered by one of the Commissioners, but the Commissioners are not bound to put the tax payer on oath. The Commissioners, by a majority of their number, may cancel, vary or confirm an assessment.

The onus is on an appellant to show that the assessment against which he is appealing is wrong. This point has been the subject of a number of Court decisions.

The decision of a majority of the Commissioners is final with regard to questions of fact and can only be challenged on a point of law other than in exceptional circumstances. An appeal from the Commissioners is to the High Court which on a question of law may reverse, confirm or amend the decision of the Commissioners or remit the case back to the Commissioners.

From the decision of the High Court an appeal lies to the Court of Appeal and thence with the consent of the latter to the House of Lords.

There is also a Board of Referees composed of experienced business men appointed by the Treasury which acts as a specialised Court in connection with certain special appeals such as matters affecting sur-tax assessments on companies, assessments of non-residents, and the determination of wear and tear allowances in particular cases. Appeals from their decisions may be made under conditions similar to those relating to the General and Special Commissioners.

POSSIBLE FUTURE ALTERATIONS

The Chancellor of the Exchequer recently appointed a Committee with the following terms of reference:

> To enquire into the method of computing net trade profits for the purpose of charging them to income tax and to consider the question of the basis period to be taken in assessing the tax on the profits so ascertained; to enquire into the method of computing net profits for the purpose of charging them to profits tax; and to report upon any alteration of the tax law which may be desirable.

It may interest you to know that a member of the Council of the Institute of Chartered Accountants in England and Wales has been appointed a member of this Committee.

The Auditor's Responsibility to the Public

From the July bulletin of the Ontario Securities Commission

WHEN reporting upon financial statements filed with this Commission in support of a prospectus, the auidtor is faced with grave responsibilities. Of necessity, the Commission must rely on the ability and integrity of the auditor to place before the prospective purchasers of the securities offered an accurate accounting of the company's financial position and past operations.

It is of primary importance that the auditor acquaint himself with the provisions of the various sections of the *Securities Act, 1947,* dealing with prospectuses and the accompanying financial statements and reports. It will be seen that one of the basic principles on which the Commission operates is that a full, true and plain disclosure of all material facts be given the prospective purchasers of the securities offered by the prospectus. In order that such a disclosure be given, it is essential that all headings and captions in the financial statements are clearly and concisely stated and conform with usual accounting terminology and are readily understandable to the layman.

The Act stipulates that the auditor's report on the balance sheet contain "a reasonably comprehensive statement as to the examination made". It appears therefore that in addition to any other remarks considered necessary by the auditor, this report must clearly indicate the type of audit made. A report which attempts to comply with this requirement by merely stating that "We have examined the balance sheet of — Company Limited" is in most instances considered inadequately worded. It has been found that usually where such a report has been presented a test audit has been made and if so, we would consider acceptable a comment such as, "We have examined the balance sheet of — Company Limited as at — 1949, and in connection therewith we made a general review of the accounting methods and examined or tested the accounting records of the company but we did not make a detailed audit of the transactions". If a detailed audit has been conducted, the report must so state and set out the period covered by such audit.

The auditor's opinion on the accuracy of the balance sheet must be clearly expressed and not be so qualified as to render it useless to an investor.

The reports on the other financial statements (where required) must also be clearly and concisely worded. Care must be taken, of course, that the various financial statements and reports comply with the provisions of the Act.

It cannot be too strongly recommended that the auditor make a practice of reviewing the entire prospectus before the material is submitted to the Commission. This practice would reveal avoidable discrepancies between information in the narrative of the prospectus and information appearing in the financial statements.

Some Aspects of Income Taxation in Canada

By Charles Gavsie, C.B.E., B.A., LL.M.
(Co-ordinator and Chairman of the Executive, Dominion Income Tax Division)

A survey of the Canadian income tax in relation to certain special topics

I. TAXATION OF CORPORATE INCOME

IN CANADA the tax payable by a corporation is, except in the cases specifically mentioned in the Act, an amount equal to 30% of its taxable income for the year or its taxable income earned in Canada for the year as the case may be.

The shareholders, in computing their income for the taxation year, must include amounts received in the year as, on account or in lieu of payment of, or in satisfaction of, dividends, which includes stock dividends. In the case of *In re Walter Crassweller,* recently decided by our Income Tax Appeal Board, it was held that a distribution by a going company of its capital profits would be income in the hands of its shareholders.

Undistributed Income

Canada does not impose a corporate tax on the undistributed income of a corporation. In this connection it might be interesting to note article XIII of the Tax Convention with the United States, which reads as follows:

> Corporations organized under the laws of Canada, more than 50% of the outstanding stock of which is owned directly or indirectly throughout the last half of the taxable year by individual residents of Canada, other than citizens of the United States of America, shall be exempt from any taxes imposed by the United States of America with respect to accumulated or undistributed earnings, profits, income or surplus of such corporations. With respect to corporations organized under the laws of Canada not exempt from such taxes under the provisions of this article the competent authorities of the two contracting States will consult together.

Business Income

The income of a corporation for tax purposes is all the income for the year from all sources inside or outside Canada including income for the year from all businesses and property. Business includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes a venture or concern in the nature of trade but does not include an office or employment. Subject to the specific provisions in part I of the Act, income for a taxation year from a business or property is the profit therefrom for the year.

A paper read at the 47th annual meeting of the D.A.C.A., Toronto, Sept. 15

The term "profits" as used in the Act is not defined. It would appear that the profits would be arrived at on ordinary commercial principles subject to such provisions of the Act as require departure from such ordinary principles.

It would appear, therefore, that the business income of a corporation would include the results of all its undertakings and ventures in the nature of trade during the year except any transactions of a capital or investment nature, which are not part of a scheme for profit making or trade.

A Recent Case

The latest Canadian case on this question is that of *Atlantic Sugar Refineries Limited* v. *Minister of National Revenue* [1948] C.T.C. 326. The headnote reads:

> The appellant was incorporated with powers to buy, sell or otherwise deal in, import, export, manufacture, refine, clarify, and otherwise prepare for market, sugar, syrup, etc. Its normal business activities were to buy raw sugar, refine and sell it. In its ordinary course of business it did not sell raw sugar. Twice in its history it undertook transactions on the raw sugar futures market: in March and April, 1937, and again in September and October, 1939. In 1937 it made a small profit of $212.10, which it treated as an item of profit as part of its ordinary earnings for that year, but in 1939 it recorded its transactions on the futures market in a private journal and did not include them in its profits and loss account. The reason given for this was that such transactions were outside the ordinary business of the appellant and were regarded by it as gambles or speculations. In assessing the appellant for the year 1939 the Minister added to its income the profits from its operations in raw sugar futures amounting to $71,183.09. From such assessment an appeal was taken to the Minister who confirmed it on the ground that the appellant's profit from its raw sugar futures operations was income within the meaning of the Act. From this decision the appellant appealed to the Exchequer Court. The issue on the appeal was whether the profit of the appellant on its dealing in raw sugar was taxable income within the meaning of the definition of income in section 3 of the Income War Tax Act.
>
> Held, (i) That there are many transactions of a speculative nature that are nevertheless trading or business operations the profits from which are assessable to income tax.
>
> (ii) That there was nothing of a capital or investment nature in the appellant's transactions.
>
> (iii) That the profit of the appellant from its sales and purchases in the raw sugar futures market may fairly be regarded as a gain made in an operation of business in carrying out a scheme for profit making and that the profit was properly included as an item of taxable income and that the appeal should be dismissed with costs.

The Exchequer Court's decision was affirmed by the Supreme Court of Canada quite recently.

"Income" is not defined in the Act, although section 6 and following contain specific provisions of amounts to be included in computing income.

The Courts in Canada have had occasion to make statements concerning the word "income". It has been said that:

> (1) income is the fruit only and never the tree;
>
> (2) capital must not be confused with income, which is equivalent to the expression of "balance of gains and profits";
>
> (3) it is necessary in each case to examine the circumstances and see what the sum really is, bearing in mind the presumption that "it cannot be taken that the legislature meant to impose a duty on that which is not profit derived from property but the price of it".

The difficulty in distinguishing between capital gains not subject to tax and those gains which constitute income

is accentuated in the case of companies having wide corporate powers. In the case of such companies any transaction or operation which results in profit may create a liability to tax unless it is the disposal of a capital asset.

II. EXPENSES INCURRED AS A CONDITION OF EMPLOYMENT

The Taxation Division in administering the *Income War Tax Act* had for some time interpreted the law as treating salary as net in itself and, therefore, not subject to any reduction. This view was confirmed by the opinion of Mr. Justice Audette in *In re Taxation of Lieutenant Governors' Salaries* [1917-27] C.T.C. 190. However, the Exchequer Court judgment in the case of *Bond* v. *Minister of National Revenue* [1946] C.T.C. 281 and *Rutherford* v. *MNR* [1946] C.T.C. 293 upset this interpretation. These decisions held that bar fees paid by practising lawyers employed as salaried officials were allowable deductions from salary. In addition, in the case of *Cooper* v. *Minister of National Revenue,* recently decided by the Exchequer Court, it was held that union dues paid by an employee who had to be a member of the union to continue his employment were a deductible expense. However, the Act was amended in 1948 to provide that in computing the income from an office or employment no deduction other than those specifically provided in the Act could be made for a disbursement or expense laid out for the purpose of earning the income.

Under the *Income Tax Act* in computing the income from an office or employment no deduction can be made except those specifically provided. The deductions specifically provided for are:

(1) Employees' contributions to approved superannuation or pension funds or plans within the limits specifically stated;

(2) Amounts paid by the taxpayer pursuant to a judgment in an action for divorce or judicial separation or pursuant to a written separation agreement as alimony or other allowance payable on a periodic basis as maintenance if the parties are living apart;

(3) Reasonable amounts actually expended by commission agents to earn their income when they are required by their contracts to pay their own expenses and are ordinarily required to carry out their duties away from their employer's place of business. Such deductions are limited to the amount of the commissions received during the year.

(4) Reasonable amounts actually expended by a transport employee for meals and lodging to the extent that he is not reimbursed therefor and who is required to pay for them while away from the metropolitan area in which his employer's establishment is located.

In addition budget resolution No. 7 of the Minister of Finance's speech of March 22, 1949, reads as follows:

> That, for the purpose of computing income of the 1948 and subsequent taxation years of a member of the clergy or of a religious order or a regular minister of a religious denomination there may be deducted the value of the residence or other living accommodation enjoyed by him as such member or minister to the extent that it would otherwise be included in his income or the rent paid by him for or the fair rental value of such a residence or living accommodation.

This budget resolution will be implemented by legislation at the present session of Parliament.

III. DEPRECIATION

The *Income Tax Act* does not contain a provision for the allowance of depreciation under that name. Section 11 (1) (a), however, provides for a deduction in computing the income of such part of the capital cost to the taxpayer of property or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation.

As you know, no regulation has as yet been issued. The Minister of Finance has, however, made certain announcements with respect to it. The following is a summary of the proposal.

1. In order to comply with the provisions of section 11 (1) (a) of the Act, a new procedure has been evolved, one of the main objects of which is to ensure that a taxpayer will be allowed to recover the capital cost to him of property. This is a departure from the old procedure, particularly in that loss in value of assets from causes other than strictly wear and tear, such as obsolescence, will be recognized as a legitimate charge against income. As a corollary to this, however, deductions from profits will not be allowed in excess of that portion of the capital cost which is ultimately established to have been actually lost. This means that if upon disposition of an asset it is found that the amounts previously allowed as deductions from income exceed the loss actually suffered, the excess will be brought back into income.

2. *Reducing balance method*

In the interests of simplicity it is proposed to establish a relatively small number of general rates of depreciation and it will be provided that these rates will be applied each year on what is known as the reducing balance method. Use of this method will entail substantial increases in the present straight-line rates of depreciation. In order to write-off an asset in approximately the same period of years, it means that the rates to be used on the reducing balance method will have to be approximately double the present straight-line rates.

3. *Assets Bought Prior to 1949*

While, as stated above, the new procedure will allow a taxpayer to recover out of income what was formerly treated as a capital loss, it is proposed not to bring into income any profits arising as a result of depreciation having been allowed prior to 1949. To accomplish this end it will be provided that the capital cost of all property owned by a taxpayer at the beginning of 1949 will be the depreciated value according to the records of the Department at the end of 1948 and that any proceeds on disposition of such assets in excess of that value will be treated as a capital profit. There will, however, be exceptions in the case of the sale of those assets subject to double depreciation or special depreciation granted by the War Contracts Depreciation Board. In addition, in order to eliminate any possibility that the new procedure results in the taxing of capital profits, the excess of the proceeds from the disposition of any asset acquired in 1949 or thereafter over the original cost thereof will be treated as a capital profit.

4. *Mechanics of Calculations*

As stated above, a relatively small number of groups of assets will be set up, each group carrying a different rate of depreciation. The mechanics of the system will be that in each group the starting point will be the Departmental depreciated cost at the beginning of 1949 to which will be added the cost of additions and from which will be deducted the proceeds of disposals during the year. The deduction to be allowed from profits in that year will be determined by applying to the figure so arrived at the rate applicable to that group and the amounts so allowed will be deducted from the

capital costs of that group to arrive at the starting figure for the next year. If, at any time, there is a credit balance in the account representing any group of assets, it will be transferred to income and subjected to tax.

If, at any time, a taxpayer has disposed of all the assets in one group and there still remains an undepreciated capital cost for that group, it will be allowed as a deduction from income in the year of disposal.

5. *Not set up on books*

One of the features of the new procedure will be that the taxpayer may claim on his return the deduction of any amount from nil to the maximum regardless of the amount set up on his accounts and also regardless of whether his operations for that year resulted in a profit or a loss.

6. *Cases of hardship*

It is realized that there may be exceptional cases where, for various reasons, application of the reducing balance method may result in depreciation allowances drastically reduced from those that would have been allowed if the straight-line method had been continued. Accordingly, it is being suggested that the Minister be given power for a limited period to grant relief in such case if the taxpayer can satisfy him that he is suffering undue hardship.

Special Depreciation

Where a taxpayer has been allowed extra or special depreciation on an asset in years prior to 1949, it is proposed to recover the extra depreciation, that is, the amount over and above normal, if the asset is disposed of at a profit. Certain provisions in this connection have been in the law for some time. However, the old provisions required reopening the assessments for the years in which the special depreciation was allowed. It is proposed to fit the sale into the new general scheme and no longer require re-opening old assessments.

After graduating from Dalhousie University and Harvard Law School, Mr. Charles Gavsie practised law in Montreal. During the war he was attached to the Legal Branch, Department of Munitions and Supply, and in 1945 he was appointed general counsel of the Department. For his work in this connection he was made a Commander of the Order of the British Empire. Mr. Gavsie is now co-ordinator and chairman of the Executive Committee, Taxation Division, Department of National Revenue.

To do this it is proposed to define capital cost of such assets at the beginning of 1949 as being original cost less normal depreciation accumulated to the end of the 1948 fiscal period. If the asset is sold in 1949 or a subsequent year for an amount in excess of this capital cost, the excess is considered to be a capital profit: if sold for the amount of the capital cost or less, the proceeds shall be deducted from the other depreciable assets.

To illustrate:—

Suppose that a building bought in 1945 cost	$100,000
Depreciation allowed to the end 1948 were	90,000
The net value for allowance in 1949 is	$ 10,000

If the building were sold in 1949 for $20,000, the ordinary rule is to regard the $10,000 profit as a capital profit. However, the taxpayer was allowed extra depreciation amounting to $80,000.

Total depreciation allowed	\$90,000
Normal $2\frac{1}{2}\%$ of \$100,000 for 4 years	10,000
	\$80,000

Therefore, \$10,000 of the \$20,000 realized is recovery of cost still on the books and the other \$10,000 is recovery of the extra depreciation allowed. It will be necessary to deduct the whole \$20,000 from the undepreciated balance of other assets on hand.

IV. INVENTORY VALUATION

Section 14 (2) of the *Income Tax Act* provides that, for the purpose of computing income, the property described in an inventory shall be valued at its cost to the taxpayer or its fair market value, whichever is lower, or in such other manner as may be permitted by regulation. The term "inventory" is defined as a description of property the value of which is relevant in computing a taxpayer's income from a business for a taxation year.

This rule sets forth what I believe is a recognized commercial rule. It should be noted that this is a rule for determining the profits of the business for the year which, in general, must be taken to consist of the difference between the receipts of the trade or business during the year and the expenditure laid out to earn these receipts. In making up the account of profit and loss for the purpose of ascertaining the difference, no provision can be made for eventualities which may be certain but have not yet happened or have not had time to reflect themselves in the returns of the business.

Under the law the profits are the profits realized in the course of the year. An exception is recognized where a trader purchased and still holds items in inventory which have fallen in value. No loss has been realized, nor may it ever occur. Nevertheless, at the close of the year he is permitted to treat these items as of their market value.

Fundamentally the taxing authorities are concerned with the ascertainment, in the greatest possible degree of accuracy, of the profits from a business in the particular taxation year under assessment and naturally look with disfavour upon any valuation of inventories which has the result of producing a figure of profit or loss more artificial than real.

In valuing inventories, no difficulty will arise where the cost of the actual articles on hand at the close of the year is known. This value where it can be proven will be accepted. The difficulty arises where the facts cannot be proven and assumptions are made.

The so-called "basic stock", "average cost", "Fifo" and "Lifo" methods of inventory valuations are not in fact methods of valuation at all but are rules of presumption as to identity of the inventory to be valued.

Identification of Inventory

The Act does not lay down any rules for the identification of the inventory on hand at the end of a taxation year and the acceptance or rejection by the taxation authorities of one or other of the presumptive rules of identification of inventories, where these cannot be accurately identified, remains a matter for determination in the light of the facts of each particular case.

In the past the taxing authorities have looked unfavourably in varying degree upon such rules of presuming identity of inventory as "basic stock", "Lifo" and "Average Cost". The fundamental reason for disfavour of these presumptions may be attributed to the fact that the

taxing authorities considered that the basis of these rules is the very antithesis of sound business procedure inasmuch as most things deteriorate through age and consequently every business is desirous of moving its old stock first. Some persuasive arguments have been advanced from time to time to show that in particular businesses the application of one or other of the "basic stock", "Lifo" or "Average Cost" theories for presumption of inventory identification more nearly corresponds with reality than the "Fifo" theory. The taxing authorities are not beyond sound argument in support of any such contentions on the part of taxpayers and are prepared to treat cases upon their merits. The test, however, must continue to be: "In the absence of positive identification of the inventory on hand, which rule of presumption is most likely to present the result most closely akin to reality?"

Once having determined the identity of the inventory, the time honoured rule for valuation, now incorporated into legislation, may be applied. But the problem does not end here. When the inventory on hand is raw material, no serious problems will arise. But different considerations may apply when the inventory consists of goods in process of manufacture or of finished articles. There are no doubt several methods in vogue for the valuation of such articles and the taxing authorities have and will probably continue to accept any method of costing such articles as appears to it to be proper in the circumstances.

Importance of Consistency

Before concluding my remarks on this phase of the subject of taxation, I think I should mention that the taxing authorities regard consistency in method of inventory valuation as of primary importance and, generally speaking, changes of method once adopted and accepted will not be sanctioned without some adequate reason and then subject only to any adjustment in taxes which may be required to offset any profit change resulting from the change of method of valuation.

V. TAXATION OF NON-RESIDENTS AND FOREIGN COMPANIES

The basic concept of taxation in Canada of a non-resident is that of taxing income having its source in Canada.

Thus, the Act provides that a person who is not taxable as a resident, but who was employed in Canada at any time in the year or carried on business in Canada at any time in the year, shall pay an income tax as required by the Act upon his taxable income earned in Canada for the year as determined in accordance with section 30. The income which is subject to tax is the part of his income for the year that may reasonably be attributed to the duties performed in Canada or the business carried on by him in Canada minus the aggregate of such of the deductions from income permitted for determining taxable income as may reasonably be considered wholly applicable and of such part of any other of the said deductions as may reasonably be considered applicable.

Part II of the Act provides for the payment of a tax by every non-resident person on every amount that a person resident in Canada pays or credits, or is deemed by part I to pay or credit to him as, on account or in lieu of payment of, or in satisfaction of, the items therein set out. Practically all these items are of a category unrelated to the duties performed in Canada or the business carried on in Canada by the non-resident, for example, dividends, interest, income of or from an estate or income, rents and royalties. As indicated in part II, the tax is imposed by way of withholding.

In applying these sections of the Act to non-residents, the effect of the Tax

Conventions between Canada and the several countries must be examined. Where there is conflict, the Convention or Agreement prevails. For example, a non-resident who was employed in Canada at any time in the year, may escape taxation in Canada in respect of his compensation if he is a resident of the United States of America and conforms to either of the conditions set forth in article VII of the Convention, or if he is a resident of the United Kingdom and is exempt by article IX of the Tax Agreement with the United Kingdom. Similarly a resident of either of these countries who is liable to Canadian tax by reason of carrying on business in Canada may escape Canadian taxation if there is no permanent establishment in Canada within the meaning of the respective Agreements.

What Constitutes Residence?

As I have indicated above, a corporation resident in Canada is taxable on its world income. Its residence is not determined by ascertaining its country of incorporation. Place of residence of a corporation, as in the case of an individual, is a question of fact, and the rules to determine this are analogous. The leading decision on this point is that of the Privy Council in *B.C. Electric Railway Co.* v. *The King* [1946] C.T.C. 224. Viscount Simon in dealing with the question of residence says:

> The company was incorporated in the United Kingdom and had its registered office in England. It was registered in British Columbia as an extra-provincial company under the Companies' Act of 1897 of British Columbia. Under the Companies' Act 1929 of the United Kingdom (19 and 20 George V. Ch. 23) its register of members was kept at its registered office, and under section 103 of that Act it kept a Dominion register of members resident in Canada at its offices at Vancouver. The stock on this register can be transferred only on the register in England. More important than these technical details, however, are the following facts, which left it beyond dispute that the company, though of United Kingdom origin, was "resident" in Canada. The company carried on the business of supplying electric power and light and operating electric railways and motor omnibuses in British Columbia and had its head office at Vancouver. Since 1929 the whole business of the company, except certain formal administrative business, was required by its articles of association to be controlled, managed, conducted and carried on in Canada. All general meetings of the company and all meetings of directors were required to be held in Canada, and all directors were required to be resident in Canada. All its assets, excepting certain records and books of accounts kept at its registered office in England and certain cash remitted there from time to time, were situated in Canada. All the income from which its dividends were paid was earned in Canada. In short, the undertaking of the company which produced its profits was in every respect Canadian and, in the sense in which "residence" is attributed to an incorporated company for income tax purposes, the "residence' of' the appellant was unquestionably Canadian.

VI. APPEALS FROM ASSESSMENTS

I propose dealing with this subject only as it relates to assessment under the *Income Tax Act.*

Section 53 of the Act provides that a taxpayer who objects to an assessment under part I may within 60 days from the day of mailing of the notice of assessment serve on the Minister a notice of objection in duplicate in prescribed form, setting out the reasons for the objection and all relevant facts. This notice is served by being sent by registered mail

to the Deputy Minister of National Revenue for Taxation, 444 Sussex Street, Ottawa. It must be signed by the taxpayer himself or, if a company, by its authorized signing officer.

It should be noted that the filing of a notice of objection does not suspend collection action for the balance owing pursuant to the assessment. Section 48 of the Act provides that the taxpayer shall within 30 days from the day of mailing of the notice of assessment pay to the Receiver General of Canada any part of the assessed tax, interest and penalties then remaining unpaid, whether or not an objection to or appeal from the assessment is outstanding. While the *Income War Tax Act* did not contain a provision similar to section 48 of the *Income Tax Act,* Mr. Justice Thorson, in a judgment rendered on August 18th last, in the case of *Morch* v. *Minister of National Revenue,* held that even under the former Act an appeal did not automatically suspend collection action.

Upon receipt of the notice of objection the Minister must reconsider the assessment and vacate, confirm or vary it or reassess and notify the taxpayer of his action by registered mail. If the Department is of the opinion that the taxpayer's objection is well founded, in whole or in part, it, as a matter of practice, communicates with the taxpayer with a view to settling the differences and having the notice of objection withdrawn.

Where a taxpayer has served a notice of objection to an assessment and the Minister has confirmed the assessment or reassessed, a taxpayer may within 90 days from the date of mailing of the Minister's decision appeal to the Income Tax Appeal Board to have the assessment vacated or varied.

Where a taxpayer has served a notice of objection to an assessment and the Minister does not within 180 days thereafter notify the taxpayer that he has vacated or confirmed the assessment or reassessed, the taxpayer may appeal to the Income Tax Appeal Board to have the assessment vacated or varied.

The form of Notice of Appeal to the Income Tax Appeal Board is established in Order In Council P.C. 659, dated February 10, 1949, published in Part II of the *Canada Gazette* (Statutory Orders and Regulations) of February 23, 1949. As part of this notice the appellant files a statement of allegations of fact and a statement of the reasons to be advanced in support of the appeal. The notice must be signed by the appellant or, if a company, by its authorized signing officer.

This notice of appeal, in triplicate, is served on the Minister by sending it by registered mail to the Deputy Minister of National Revenue for Taxation at Ottawa. A copy of the notice is sent by the Minister to the Board. A fee of $15 must be paid to the Receiver-General of Canada upon the service of the notice of appeal. If the appeal is allowed in whole or in part, this $15 is returned. No other costs may be awarded by the Board and no fees may be charged the appellant by the Board.

Hearing of Appeal

Immediately after receiving the notice of appeal the Minister is to forward to the Board copies of all documents relevant to the assessment. The Board may request either party to file additional information relative to the assessment or the appeal therefrom. The time and place of the hearing is fixed by the Board and the parties are given at least fifteen days notice. The parties may appear in person or may be represented at the hearing by counsel or an agent or may by consent or by order file written submissions. It is planned to hear appeals at all the principal centres throughout Canada. The Board is a Court of record and may enforce the attendance of wit-

nesses and compel them to give evidence. The Board may decide to hear the appeal *in camera* or the appellant may request it to do so. The Board may dispose of an appeal by (a) dismissing it (b) vacating the assessment (c) varying the assessment or (d) referring it back to the Minister for reconsideration and reassessment. Upon the disposition of an appeal the Registrar of the Board forwards by registered mail a copy of the decision and the reasons therefor to the Minister and the appellant.

In the case of an appeal from an assessment made pursuant to a direction given under section 126, the Board has no jurisdiction to vacate or vary the assessment insofar as it is made in accordance with the direction.

Appeal to the Exchequer Court

The Minister or the taxpayer may within 120 days from the date of mailing of the decision of the Income Tax Appeal Board appeal to the Exchequer Court of Canada.

The appeal to the Exchequer Court is instituted by serving a notice in triplicate on the other party by registered mail and filing a copy thereof with the Registrar of the Income Tax Appeal Board. If the taxpayer is the appellant, he must within 30 days from the day the appeal is instituted give security for costs to the satisfaction of the Minister in a sum of not less than $400 and notice of the filing of the security is given to the Registrar of the Board. The respondent may within 60 days from the receipt of the notice of appeal serve on the appellant and file in the Court a reply admitting or denying the facts alleged and containing a statement of such further allegations of fact and of such statutory provisions and reasons as the respondent intends to rely on.

The Registrar of the Board transmits to the Registrar of the Exchequer Court the papers filed with the Board on the appeal before it, together with a transcript of the record of the proceedings before the Board. The matter is then deemed to be an action in the Court and, unless the Court orders the parties to file pleadings, ready for hearing. In effect the hearing in the Exchequer Court is a new trial. The hearing is *in camera* if the taxpayer requests it. The Court in rendering judgment may order either party to pay the costs.

An appeal from the Exchequer Court to the Supreme Court of Canada and the Judicial Committee of the Privy Council is governed by general rules relating to such appeals.

Disclosure of Partners' Liability for Income Tax

By Bernard Goodman, C.A.

Should the firm's financial statements disclose the partners' individual liability for income taxes?

THE following article, written by J. Robert White, appeared in the February 1948 issue of the *New York Certified Public Accountant:*

SHOULD FINANCIAL STATEMENTS OF PARTNERSHIPS SHOW ANY LIABILITY FOR FEDERAL INCOME TAXES?

This question is frequently raised by credit grantors as well as by other users of financial statements. It is a natural question since the partnership is the only common form of conducting a business which does not show the provision and liability for federal income taxes in its financial statements. In the cases of corporations and individual enterprises, the other two common forms of doing business, the federal income taxes are a liability of the corporation or of the individual conducting the enterprise, and there is no question but that the liability should be shown on the balance sheet or statement of assets and liabilities and that the provision therefor should be shown as a charge in the profit and loss account. However, in the case of partnerships, the liability for federal income taxes on the profits of the partnership is not a partnership liability but is the liability of the individual partners.

In addition to this legal technicality, there is a very practical problem in that it is often impossible for the partnership as such to determine the taxes that will have to be paid on the partnership income. In order to make such a determination it is necessary to know the particulars of the taxable income of each partner, and in many cases a partner might quite properly not wish to disclose this information to the other partners.

Because of these facts, it has become almost universal practice in submitting financial statements of partnerships not to include in the profit and loss account a charge for income taxes of the partners payable on the partnership income, and not to show as a liability the unpaid portion of such taxes. Also many partnership financial statements contain a footnote stating that the income taxes on the partnerships' income are payable by the partners and calling attention to the lack of provision therefor by the partnership.

The fact that income taxes claim such a large portion of the income of any enterprise probably gives rise to the argument that regardless of these facts some provision for these taxes should be made in partnership statements. But is there any more reason to show the income tax liabilities of the partners in partnership financial statements than to show other liabilities of partners in those statements?

It would seem to me that in loaning to a partnership if the credit grantor is looking to the partnership assets for re-

payment, he is interested in all of the demands that might be made for the use of those assets and not only in one demand, such as one for income taxes. If I am correct in that assumption, is not our present problem met by (1) the accountants insisting that financial statements of partnerships contain an explanatory comment that no provision for income taxes is made and no liability is shown since the liability is that of the partners and not of the partnership, and (2) the credit grantor obtaining from the borrower a statement as to what withdrawals are anticipated by the partners, whether for tax or for any other purposes?

The above problem is important enough to warrant further discussion by public accountants, since there appears to be no uniform treatment of income tax liabilities of partnerships.

Prime Purpose of Financial Statements

We are continuously reminded of the fact that independent public accountants prepare financial statements of their clients for credit grantors, tax authorities, government agencies and prospective purchasers but should we not bear in mind the fact that primarily statements are prepared for the guidance of the client?

A partnership business carried on by two or more partners requires complete and informative statements of operations for the period under review, details of changes in capital accounts during the year and balance sheets at the close of the accounting period which exhibit the true financial position of the business.

During the war years, most partnership businesses were subjected to federal excess profits taxes as well as individual income taxes. High rates of taxation created heavy liabilities for such taxes and provision for this obligation was of great significance in annual accounts of partnerships.

In some cases, auditors who studied the heavy impact of taxation advised the conversion of the business from partnership to corporate entities because the net earnings (after taxes) on a corporate basis were greater than the net earnings (after taxes) on a partnership basis, and post-war needs required considerable working capital which would be augmented if the change were made.

The heavy tax liability clearly set forth in financial statements of partnerships not only showed the partners the tremendous burden of war taxation but also clarified the financial position and created discussions concerning the advisability of seeking tax relief by filing applications for higher "standard" or "base" profits during the excess profits tax years.

E.P.T. Years

In Canada the excess profits tax on profits earned by partnerships was repealed, effective December 31, 1946, but accountants who prepared financial statements of partnerships operating during the years 1940 to 1946 dealt with the tax liability which arose under the *Excess Profits Tax Act,* which treated the partnership as though it were an entity distinct from that of the partners. The excess profits tax payable by the business was allowed as a deduction from the partners' share of net income for the purpose of determining the profits on which the partners were subject to income tax. For the purpose of the above deduction, excess profits tax exigible on the partnership business was apportioned by the taxation authorities on the basis of the total share of profits derived by each partner from the business and, of course, unequal salary distributions charged to profit and loss before division of profits, as set forth in partnership agreement, were taken into consideration.

Each partner's capital account was

therefore charged in the first place with his share of the total excess profits tax liability and a liability account "Provision for Excess Profits Tax" was credited at the end of each accounting year. Excess profits taxes were payable in quarterly instalments; for example, if the fiscal year ended December 31, 1946, two payments were made — one on the last day of September 1946 and the other on the last day of December 1946, and the balance of tax was payable in 1947. Therefore, the year-end balance sheet would normally reflect a remaining liability for at least one-half of the total excess profits tax for the year. The provision for excess profits taxes was an important item in determining "capital employed", which latter item was used in determining capital changes and adjusted "standard" or "base" profits used in the calculation of excess profits for each year. After the excess profits tax liability had been calculated, it was a simple matter to estimate individual income taxes exigible on partners' income from the business.

Let us assume that two partners operating in partnership together had virtually no income-producing assets outside the business. In other words, all taxable income originated solely by virtue of the operations of the partnership business. There are many cases of this type of operation, particularly during the first five or ten years when the business is in the experimental and development stage and partners draw only enough for bare living expenses, although the profits may be high, and leave the profits in the business. In cases of this kind, it was considered quite in order to calculate and set up on the year-end balance sheet, the income tax liability of the individual partners, as well as the excess profits tax liability

Mr. Bernard Goodman, C.A., a member of the Quebec Institute since 1931, is a partner in the Montreal firm of Goodman & Goodman, Chartered Accountants.

In Canada income taxes of individuals whose income is derived from carrying on a business is payable in quarterly installments during the fiscal year ending December 31st. The payments are based upon estimates of taxable income for the taxation year. Remittances to tax offices, in the type of operation mentioned above, would be made by cheque issued by the partnership business, and if the actual income determined at the end of the year was higher than estimate, the balance sheet would reflect "provision for income taxes" — equal in amount to item reflected in profit and loss statement, less installments paid to date of balance sheet. If quarterly tax installments due on excess profits taxes and income taxes were not paid as due, the tax accrual for the year, plus interest on overdue installments, represented a considerable item in the accounts.

Criticism From Credit Grantors

We found that bankers and other credit grantors in Canada criticized balance sheets which did not reflect income tax liabilities of partnerships.

It is true that two partners operating in co-partnership may have income-producing assets outside of the business, viz.:—

Cash in Savings Banks,
Bonds,
Stocks,
Real Estate,
Income from Estates,
etc.

Suppose partner "A's" share of partnership income is $100,000 and miscellaneous income $10,000. In practice,

he will usually pay his income taxes from partnership funds. Similarly, his partner "B" may have miscellaneous income from personal assets. What difference is there between a cash withdrawal for living expenses charged to capital and a tax liability on all income charged to capital?

Usually partners who have been in business together for some time have a very good idea of each other's private assets, and in practice I have found that if the partnership business is the main source of income, taxes on all income are paid by the business.

Suppose the two partners operate a business with a capital of $50,000, earning $15,000 a year, and each has $1,000,000 in personal income-producing assets outside the business, earning $30,000 a year. It appears to me that in cases of this kind the total income taxes will be paid personally with funds outside the partnership business. The balance sheet of the partnership business could then contain a footnote to the effect that "income taxes of the partners will be paid personally by the partners and will not be charged to the capital accounts of the accounts submitted".

Solicitation of Business

The following letter sent from Nigeria on April 29, 1949 was received recently by a Toronto firm of chartered accountants. (The word "Canada" and the phrase "Accounts of Assorted Kinds" were the only parts of the letter filled in by handwriting.)

A. Folorunso Badmus Bros.

Import Licence No— Importers & Exporters Motto Peace & Plenty follow honest Traders

Dealers in:—

Cement, Bicycles, Kerosene, Stationeries, Hats, Helments, Motor Parts, Medecine Foot-Wear, Soaps, Berrets, Oil Greeze Shirts Fezcaps, Jewelleries mouth organs Musical Instruments, engines batteries Pouches globes, watches and Clocks

Gentlemen,

Your name was introduced to us by Canada chamber of commerce that you are the manufacturers of Accounts of Assorted Kinds in which we are keenly interested. We shall deem it a great honour if you will send to us by return mail your COMPLETE RANGE OF SAMPLES, QUOTATIONS and price list.

TERMS: — 75% Cash with order and balance payable through the Post Office at Ijebu-Ode against delievery.

SAMPLES: — It has become the policy of our firm that SAMPLES should be seen before ordering for the fact that we have been much disappointed by many oversea customers with their attractive Catologues and Misleading quotations.

REFERENCES: — Available on request.

REPLY: — To be sent by AIR MAIL POST.

SAMPLE PARCELS: — Strongly adviced to be sent by SEA MAIL.
REGISTER POST FOR SAFETY.

Awaiting for your good news.

Yours faithfully,

PP. A. Folorunso Badmus and Brothers

Stockholders' Equity

By Lewis N. Greer, B.Com., M.B.A.

The term "surplus" should be broken down into its real constituents

MR. KING'S ARTICLE "Surplus" in the May 1949 issue of *The Canadian Chartered Accountant* invites comments or suggestions in order that we might make "surplus" a better understood term. In order to discuss "Surplus", I have chosen a wider field — stockholders' equity, because one cannot well discuss "surplus" without some idea of the nature of "capital stock", to which surplus is used in contradistinction.

Inadequacy of Current Nomenclature

Accountants have attached special connotations to the two terms "capital" and "surplus" and the terms are, therefore, deeply imbedded in present day accounting terminology. We are reluctant to dispense with our customary terminology. But if we are to acknowledge the responsibility of accountants as that of informing not only management but others such as employees, creditors, stockholders and regulatory bodies, of those facts which they should know about the enterprise, then the language of accounting must have meaning for the skilled and unskilled reader.

Many articles have been written on this very topic advocating the stand that I propose, and my purpose in restating this controversial problem is that in my opinion we have reached the point where our present terminology and generally accepted standards of financial reporting of stockholders' equity need revision, and acceptance of such revision by accountants and regulatory bodies.

The "net worth" section (which I prefer to label "stockholders' equity") of the balance sheet has long been a source of confusion. This is due in part to the requirements of the Dominion *Companies Act* of 1934 which I shall not reiterate at this point, but to which I shall refer later in this article.

The various committees of the Dominion Association of Chartered Accountants are at the present time working on a revision of terminology, and proposed amendments to the Dominion *Companies Act* of 1934. But to date they are reluctant to advocate the drastic changes necessary to meet the present-day demands on accounting. This is supported by an examination of their "Review of the Dominion Companies Act of 1934" wherein they continue to support the use of the word "surplus".

"Surplus" Should Go

Mr. King states in his article in the May 1949 issue of *The Canadian Chartered Accountant*:

> It is suggested that much of the confusion surrounding the term "surplus",

as used in financial statements, would be eliminated if it were used only in the following senses: contributed surplus; capital surplus; distributable surplus; and earned surplus.

I disagree. To eliminate confusion requires eliminating the term "surplus". The real meaning and significance of "surplus" is not always clear to the reader of accounting statements. Investors, businessmen, the courts, and even the accountant have often defined the term as an "excess" of assets. Although this definition may be correct in a sense, it has produced unfortunate results in the accounting for surplus and in the interpretations sometimes made from the orthodox presentation of surplus on accounting statements. In view of the fact that the accounting meaning of the word "surplus" is different from the generic meaning of the word, we should adopt more meaningful phrases to describe the nature of the various portions of the stockholders' equity. This equity is represented, at the present time, by two general elements: capital stock and surplus.

Clarify "Capital"

The term "capital" was originally used in the accounts of an individual trader to denote proprietorship, but its significance is in connection with limited companies (corporations). The limited company is a legal entity apart from its members and as such the members enjoy limited liability. As stated by Professor Smails:[1]

> A creditor can look only to the assets of the company for the satisfaction of his claim, he cannot bring action against the private estates of the individual members (as can a creditor of a partnership). For these reasons he is directly interested in seeing that the money contributed by the shareholders remains in the business and that only bona fide profits are distributed among them. Accordingly the law, while granting limited liability, held that, for the protection of creditors, capital once contributed should be regarded as incapable of withdrawal, and that it should constitute a fixed and inviolable fund.

This indicates that the first element of stockholders' equity to be disclosed is the legal capital. The present terminology used is "capital stock". By changing this to "authorized share capital" attention will be more adequately focused on this relatively fixed fund and its composition. "Authorized share capital" is advocated because the number of shares of each class of stock authorized and issued should be disclosed to inform the reader that all of the authorized share capital has been issued or that the company has issued to date a portion thereof.

"Capital surplus", described by Mr. King as "the sum of the amounts set aside from earned surplus in connection with the redemption of preferred shares of the company in accordance with the provisions of sec. 61 of the Dominion *Companies Act*", creates a false impression because it is part of the authorized share capital of the company. Capital surplus is brought about by the redemption of preferred share capital out of earnings which means that the common shareholders have agreed to permanent capitalization of earnings in order to eliminate the preference shares and thereby enhance their probability of reaping the benefits of future earnings. This amount should not be called "capital surplus" but "earnings capitalized by the redemption of preferred shares". It should appear under the caption of authorized share capital", because the legal, non-withdrawable capital remains at the same figure after as before the redemption.

Shareholders' Contributions

The second element of stockholders' equity to be disclosed is presently designated as "contributed surplus" and "dis-

[1] R. G. H. Smails, Accounting Principles and Practice (The Ryerson Press, Toronto, 1948) p. 264.

tributable surplus". I would eliminate these two terms and substitute "additional contributions by the shareholders". The Post-War Planning Committee of The Dominion Association of Chartered Accountants in their "Review of the Dominion Companies Act, 1934" advocate that the above be designated as "contributed surplus" — consisting of

(a) surplus arising from the issue, redemption or alteration of the company's own share capital including, inter alia,
  (i) premiums received on the issue of share capital;
  (ii) surplus arising from the conversion of shares of one class into shares of another class;
  (iii) discount on the redemption or purchase for cancellation of any share capital;
  (iv) that portion of the consideration for the issue of any shares heretofore set aside as distributable surplus;
(b) donations of cash or assets by shareholders.

I agree with their composition, but we should eliminate the word "surplus" and disclose the fact that the stockholders' equity in the company is increased because of the "additional contributions by the shareholders". The fact that these items may be legally distributable to the shareholders in the form of dividends is of no great significance in the financial statements because it is not the immediate intention (if ever) to distribute them to the shareholders. The fact that some or all of the contributions are legally distributable can be disclosed either parenthetically or as a footnote.

"Earned Surplus!"

The third element of stockholders' equity which is at present termed "earned surplus", means 'accumulated earnings', or 'undivided earnings' or 'retained earnings' and should be designated as such. The majority of accountants agree that this item should consist of the sum of the profits from operations and other gains, including the realized capital gains and losses other than those arising from transactions between the company and its shareholders.

On obtaining his Bachelor of Commerce degree from the University of Saskatchewan, Mr. Lewis N. Greer was appointed accounting instructor in the University's College of Commerce. He received the degree of Master of Business Administration at the University of Chicago this summer.

To ensure adequate disclosure, the company should give a detailed explanation as to why and how the "retained earnings" are employed within the business. This explanation will inform the reader as to why the earnings have not been distributed to the shareholders.

There is one other item that is generally termed "surplus" and I feel that Mr. King's proposal is very satisfactory. He states:

> In some instances the book value accorded assets of a company is increased as the result of an appraisal of the assets. The offsetting credit is often classified as an "appraisal surplus", or a "revaluation surplus". Since this amount records an increase in the value accorded to the assets which is not earned, it should not be described as a surplus item. This amount, in fact, represents the difference between the previously written down book value of the assets and the estimated realizable or depreciated replacement value and would be more appropriately described by some term such as "unrealized appreciation in fixed assets".

By adopting the above presentation of the stockholders' equity, confusion is eliminated because the source of each portion of this equity is disclosed and phrased in simple fact-giving language

which enables the reader to grasp the meaning and significance. A comparison of the disclosure advocated by Mr. King and that presented above brings this fact into sharp focus without further comment.

As proposed by Mr. King

1. Capital Stock
2. Capital Surplus
3. Contributed Surplus
4. Distributable Surplus
5. Earned Surplus
6. Unrealized Appreciation in Fixed Assets

As proposed above

1. Authorized Share Capital
2. Additional Contributions by the Shareholders
3. Retained Earnings
4. Unrealized Appreciation in Fixed Assets

Changes in accounting terminology and financial statements should be limited to those that will lead to improved standards. These changes should be made only after the members of the entire accounting profession have given serious consideration thereto and have signified their willingness to endorse them without reservation or exception. Therefore, the above suggestion of a possible improvement is presented with the thought that it will stimulate such discussion, leading finally to a logical and truthful presentation of stockholders' equity.

Professional Notes

ONTARIO

Mr. J. W. McDougall, C.A., Ottawa, has been appointed assistant professor of accounting at Carleton College, Ottawa.

* * *

Glick & Levine, Chartered Accountants, announce the removal of their offices to Ste. 1206, New Wellington Bldg., 137 Wellington St. W., Toronto, Ont.

* * *

BRITISH COLUMBIA

Mr. Richard C. Field, C.A., 509 Royal Trust Bldg., Victoria, B.C., announces that Mr. Richard A. Roberts, C.A., formerly of Winnipeg, will be associated with his office as a consultant.

Report of 47th Annual Meeting

By Clem L. King, B.Com., C.A.
(Secretary, The Dominion Association of Chartered Accountants)

THE forty-seventh annual meeting of The Dominion Association of Chartered Accountants was held at the Royal York Hotel in Toronto, Ontario, from September 9th to 16th, 1949.

The Executive Committee met on Friday evening, September 9th, Saturday morning and evening, September 10th, and on Friday morning, September 16th. Council met on Monday afternoon, September 12th, Tuesday morning and afternoon, September 13th, and Friday morning, September 16th. The Committee on Education and Examinations met on Monday morning and afternoon, September 12th. The Committee on Public Relations met on Tuesday morning, September 13th, and the Advisory Committee on Uniform Regulatory Legislation met on Monday afternoon, September 12th. General sessions were held on Wednesday and Thursday mornings and afternoons and the forty-seventh annual general meeting was held on Friday morning, September 16th.

The Institute of Chartered Accountants of Ontario provided a varied programme of special events which the members and their ladies enjoyed. The Tuesday evening reception provided an opportunity to renew old acquaintanceships and make many new ones and the dancing and entertainment launched the annual meeting in a spirit of friendliness and goodwill. The members' luncheon at noon on Wednesday was well attended as were all the other functions. On Wednesday the visiting ladies travelled to Niagara Falls where lunch was served in the Rainbow Room of the General Brock Hotel. On Thursday the President of the Ontario Institute and the President of the Dominion Association were joint hosts to the members of Council, the Ontario Institute executive committee and committee on arrangements and their ladies. The visiting ladies were taken to the Ontario Jockey Club for lunch and the afternoon's racing programme. The stage presentations on Thursday evening met an enthusiastic response and the evening provided a further opportunity to meet with friends and acquaintances. On Friday afternoon the visiting ladies were taken on a tour of the city and to tea at the Old Mill, returning in time for the dinner and dance which climaxed the week's activities.

All the technical and business sessions were well attended and the discussions

following the presentation of papers indicated that the members found them interesting and stimulating.

On Wednesday morning Mr. E. J. Howson presided at the session at which Mr. J. William Horsey, Mr. A. C. Ashforth, Mr. R. A. McEachern and Mr. C. Elliott presented papers dealing with "The Use and Presentation of Published Financial Statements" from the point of view of the business man, the banker, the financial editor and the investment counsellor respectively.

At one of the two sessions on Wednesday afternoon, Mr. J. R. M. Wilson presided at the session at which the panel discussion group, under the leadership of Mr. K. LeM. Carter, discussed the question "Should confirmation of accounts receivable and observance of physical stock-taking be considered normal auditing procedure?". Mr. W. J. Ayers and Mr. J. R. Church advocated the affirmative in respect of accounts receivable and inventories, while Mr. Jean Valiquette and Mr. J. G. Brown presented the arguments against such procedures being considered as normal. Mr. Carman G. Blough, Director of Research of the American Institute of Accountants, presented an excellent outline of how such procedures came to be adopted by the members of his organization and the extent of its acceptance in the U.S.A.

At the other session on Wednesday afternoon, Mr. R. Bruce Taylor was chairman of the group, composed of Mr. H. B. Halliday, Mr. R. A. Hicks, Mr. R. L. B. Joynt and Mr. G. T. R. Plummer, who presented papers and led the discussion on the topic "Saving time and money in the office".

On Thursday, under the chairmanship of Mr. F. E. H. Gates, "The taxation of business income in Great Britain, the United States and Canada" was covered in excellent addresses by Mr. B. H. Binder, Mr. P. F. Brundage and Mr. C. Gavsie. On Thursday afternoon Mr. R. W. E. Dilworth presented a paper dealing with certain aspects of the new Income Tax Act not included in the scope of the preceding papers.

At its Friday meeting Council elected the officers for the 1949-50 year and appointed the chairmen of the various committees.

At the forty-seventh annual general meeting of the Association, by-law No. 1 was amended by unanimous vote to recognize the Institute of Chartered Accountants of Newfoundland as one of the constituent Institutes of the Association.

The reports of the various committees were presented to Council and discussed at considerable length. These reports will be published in their entirety in the forthcoming Year Book.

The Committee on Accounting and Auditing Research reported that it had been working on three bulletins dealing with the determination of income. The first of these, on bad debts, is almost ready for release, the second on inventories will be ready for release as soon as consideration can be given to any regulations to be issued by the Department of National Revenue on this topic and in the case of the third dealing with depreciation, preliminary studies have been undertaken. In addition, the Committee has given extensive consideration to the question of a bulletin on auditing standards and its possible content. The Committee has also been proceeding with the revision of the manual "Accounting Terminology for Canadian Practice".

The Committee on Education and Examinations reported that it had decided to expand the Board of Examiners-in-Chief by three members in order to provide for representation on

a regional basis. Starting with the 1949 examinations, the Board is arranging to have the examination papers marked by individuals working during regular office hours and as a group, rather than completing the task in the evenings and working individually. The Board hopes that not only will the results be available at an earlier date, but also that it will be much easier to maintain uniformity of grading between the various papers and candidates. The 1950 examinations are to be held during the first week of November or the closest date thereto that is practicable.

The Sub-Committee on Personnel Selection reported that the Executive Committee, having been notified that the Institutes of British Columbia, New Brunswick, Nova Scotia, Ontario and Prince Edward Island would utilize the testing program when it became available, had authorized the testing of the sample group and the launching of the programme proper. The testing of the sample group was in progress and returns were being received at a satisfactory rate.

The Sub-Committee on Student Rehabilitation reported that it had maintained close contact with the Department of Veterans Affairs in Ottawa during the year.

The Legislation Committee reported that it had dealt with the Income Tax Act, the Bankruptcy Bill and Proposals 6 and 7 of the House of Commons Special Committee on Prices during the year.

The Magazine and Publications Committee reported on the progress of *The Canadian Chartered Accountant* during the year and on *The Tax Review*, which was first issued in January, 1949 in accordance with the 1948 decision of the Council. Council approved of the recommendation that the Year Book be published in three sections in the future. The first part, which will include the financial statements and committee and Institute reports, will be published annually. The second part, which will contain the list of officers of The Dominion Association of Chartered Accountants and the Institute officers and the lists of members of the Institutes, will be published annually. The third section, to be published at approximately five year intervals, is to contain the Acts of incorporation, by-laws, codes of ethics and other regulations of the Dominion Association of Chartered Accountants and the Institutes.

The Committee on Public Relations recommended that a member of the Association staff be responsible for public relations in co-operation with a Toronto member of the Committee. It was also recommended that public relations counsel be engaged in connection with the annual meetings or other special functions of the Association.

The Committee on Uniform Code of Ethics reported that it had received comments from all the Institutes upon the draft code which had been prepared last year and had revised the code after taking these comments into consideration. Council recommended that the code be sent to the Provincial Institutes for approval and adoption.

The various committee reports, Institute reports, financial statements and membership summaries will be published in the forthcoming Year Book.

Recent Books

Reviews of works of interest to the profession

Business Operational Research and Reports, by John G. Glover, American Book Co., New York, $4.00.

To anyone who has had a long period of contact with the business world, this book will bring a vivid realization of the differences between the successful executive of today and his counterpart of twenty-five or more years ago. At one time the sole equipment needed to head a business was an eye for a bargain. An instinct for finding ignorance or distress and taking advantage of it marked the *entrepreneur.* Even after business had reached the complexity obviously to need organization the manager was pretty well expected to operate by instinct or hunch, a gift which he probably acquired at birth as Michael Angelo or Patsy Parr did their talents. "An executive is a man who makes quick decisions and is sometimes right" was an aphorism often seen on office walls.

The newspaper and radio bring possible bargains to the attention of too many people for them to be monopolized by the specially alert or unscrupulous dealer. Business has grown so big and now accepts a responsibility to employees and the community so that errors in management are not only more costly but are recognized as an injury to others than the perpetrator or his shareholders. It is no longer sufficient to be right a majority of the time. Business today must practically never make a serious mistake.

As this book points out, management decisions, if they are to be sound, must be preceded by (1) research to collect all the known facts, (2) the arrangement, classification and analysis of the facts, (3) the interpretation of the facts and (4) the induction of a conclusion. This is not all. The decision must be accompanied by adequate plans for its execution and for checking the results.

This book is a text book on the research that should precede an important management decision. It indicates in a clear and comprehensive way the factors requiring investigation whether the problem is product, plant, materials, man-power or markets. Nor does it overlook that research is largely wasted unless the findings are well reported.

An appendix gives, amongst other specific suggestions, appropriate subjects for research on the problem of locating a business (34 pages of concise questions) and a manual on preparation of research reports issued by a large company for the guidance of its technical staff (62 pages).

The book is lucid and complete. While directed mostly at the student in business administration, it could hardly fail to benefit any executive who would read it.

R. Bruce Taylor, F.C.A.

Standardized Audit Working Papers, by Frederick Staples, C.P.A., published by the Counting House Publishing Co., Milwaukee, Pp. 277 and index, $4.50.

The first edition of this book issued in 1947 brought forth very favorable comment from members of the profession in Canada, England, Ireland, Australia and the United States. The new edition has been revised to provide larger sized sample audit working papers and there have been some changes in the form of audit reports and audit report questionnaire.

This is a very practical and instructive book.

J. A. Wilson, F.C.A.

Plain Words, by Sir Ernest Gowers, published by His Majesty's Stationery Office, York House, Kingsway, London, W.C.2, Pp. 94, 2/–.

Most of you have already heard of this book which was first published in April 1948 at the invitation of the Treasury. It is concerned particularly with the use of English by officials, but we might as well admit now that many public accountants have the same, and possibly more, faults along this line than public servants.

To those interested in writing and who wish to avoid pitfalls, this book will be found at once instructive and delightful. Some of the examples are so ridiculous that one is amazed to see their source.

In his epilogue, Sir Ernest begins with the following sentences, which can be applied as well to public accountants as to public servants.

> A book designed as a guide to officials in the use of English runs the risk of giving a false impression. It cannot help being concerned mainly with faults to be corrected, and so may make the picture look blacker than it is. The true justification for such a book is not so much that official English is specially bad as that it is specially important for it to be good.

It is unfortunate that His Majesty's Stationery Office (or the Treasury, for that matter) has not made a greater effort to make this book known and available in North America. This reviewer made inquiry at six first-rate book shops and counters in Toronto and none of them had heard of it. Finally, he was able to obtain a copy through the kind assistance of the British Trade Commissioner in Toronto. It is hoped that this review will not only entice our readers to study this guide to the use of English, but will also make some dollars available to the publishers. One cannot complain of the high cost of this British product.

R.F.B.T.

Audits and Examinations Standards and Procedures, by Christian Oehler, published by American Book Co. New York, U.S.A., Pp. 570, $5.25.

This book is designed as an instruction manual in audit and examination procedures for accounting students as well as practising accountants.

Mr. Oehler describes very thoroughly and clearly the audit procedures and methods used in verifying balance sheet, revenue and expense items. Because each important procedure is presented in a form enabling the accountant to know what to do when confronted with a given situation, it is an excellent reference book for both student and practising accountant. Further the book is exceptionally well cross-indexed thus improving its value as a reference book.

Although written and published in the U.S.A. it aptly applies to auditing procedures here. Senior students and practising public accountants will find this book interesting and a useful addition to their libraries.

K. W. Ball, C.A.

Handbook of Cost Accounting Methods, J. K. Lasser, C.P.A., Editor; D. Van Nostrand Co., Toronto, 1949, 1284 pages, bibliography and index, $10.50

The professional accountant is familiar with the *Handbook of Accounting Methods,* edited by Mr. Lasser, which became in the few years since its appearance a welcome source of information on accounting methods for a great variety of businesses and industrial enterprises. It can be justly claimed that the new *Handbook of Cost Accounting Methods* will play an equally important role in the field of cost accounting.

Section I of the book is an integrated series of articles by authorities which show how the techniques can be used as an instrument for management controls as well as for profit.

Section II of the book is applied cost accounting to a diversified range of industries and systems, selected so that other businesses can readily find in it immediate and great value.

Section III contains a carefully classified bibliography.

The contributors to Section I include such well-known accountants as Maurice E. Peloubet, C.P.A., known as the father of the LIFO method, who writes the leading article "A General Survey of Cost Accounting, Its Problems and Setting", Professor C. W. Sargent, author of 8 chapters, Professor Carl Thomas Devine, contributor of 5 chapters, and T. H. Patterson, who covers 4 chapters on Techniques, Procedures, Forms, etc. The 70 contributors provide a veritable mine of up-to-the-minute cost accounting information for accountants, engineers, and business advisers. Prototypes of systems which can be adapted for every kind and type of business and industry will be found in the volume.

Section II contains 61 articles on cost accounting in specific industries; it is hard to find any line of manufacturing which is not represented either directly or through an article on a closely related industry. Industries not usually discussed in *cost* accounting texts, like drug wholesaling, hospitals, hotels and clubs, municipal cost accounting, are included. The articles in a collective volume are naturally not all of the same standard. The guiding hand of the editor can be traced through the lay-out of the articles on the various lines of industry, which in a uniform way start with a description of the particular industry and follow through with the design and description of the cost system for this line.

A volume of 1344 pages is, of course, pretty heavy and clumsy to handle. There is no doubt, however, that this standard work will be used by an impressive number of public accountants, to whom it presents convenient answers to problems posed by their clients, by accountants and especially cost accountants in industry, also by management and economists who may seek there the answer to their problems. Commerce and Finance professors and their students will welcome especially the basic articles of the first section which deal with a number of matters not easily found in the current text books.

Every student-in-accounts and also most practitioners will be well rewarded for reading Chapter 4, "Major cost problems in business" by Professor Sargent, which is an excellent summarization of the present stage of cost accounting and a very handy condensation of the major questions in costs. The article deals for instance with the cost-revenue-profit-volume representation, the developed break-even chart or profit graph, not often fully described in current text books.

George Moller, C.A.

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

FOR THE practising accountant the real problem of consolidated financial statements must, we submit, be more than merely shepherding figures safely through the columns of wide work sheets. The real problem, the basic thing of all, must surely lie in deciding whether or not the preparation of consolidated financial statements is going to make the financial picture any clearer. Goodness knows many of our corporate set-ups are extremely complicated. Perhaps we are expecting too much to have a single balance sheet and income statement that will tell us the whole story at a glance.

The preparation of consolidated financial statements should, we suggest, be set against the simpler alternative of separate balance sheets and income statements for the parent company and each of the subsidiaries. Besides being simpler, which is quite enough to recommend it for most of us, the alternative mentioned puts the spy glass on things. A family of associated companies, like any other family no doubt, only moves harmoniously as a group if you look at it from a distance. It is an unfortunate statistical proposition that the further one gets away from the basic data (as where statistical techniques such as consolidation intervene), the less reliable is his information going to be.

On the other hand, the simpler alternative, in common with many another idea, is not quite as simple as it sounds on first hearing. In addition to the individual balance sheets and income statements of the parent company and each subsidiary we would need some supplementary information. First of all, we should have an indication of the extent of the parent company's ownership in each subsidiary. Secondly, we would need a report of the effects of significant inter-company transactions upon the profits of the various companies. (Any interpretation of the separate statements assumes that there has been no manipulation of profits by inter-company transactions.) The consolidated form of presentation must at least be given points for the fact that it eliminates this effect as a preliminary to the preparation of the consolidated income statement.

* * * *

The technique of preparing consolidated financial statements is, in a way, an averaging process. Of course we do not divide by the number of companies involved when everything else is done, but we do end up with an aggregate of data to interpret. And what can we ever do with an aggregate except infer some sort of average from it? Presenting us with an aggregate is one way of compelling us to assume that the overall picture we are given is representative of the components. We hasten to say that what one adds together in preparing a consolidated balance sheet are still the parent company's investments in various

subsidiaries. The difference is that in place of the single figure for cost to the parent company, the investments are each expressed in the form of assets — liabilities (including minority interests). Consolidation is a process of enlarging on the parent company's most important asset (investment in subsidiaries).

Having said this, we submit that consolidated financial statements are subject to all the weaknesses of an average. The point is, an average is not meaningful unless the individual items from which it is computed have more or less the same magnitude. If this is not the case, the average is simply not a representative measure and it becomes misleading to use it. We can emphasize our point this way: think of a day in June (any one will do) in which the temperature during the daytime is 60 degrees, but falls to 26 degrees at night. Can you console a gardening enthusiast by telling him that the average temperature over the twenty-four hours was 43 degrees?

Suppose then that one subsidiary company is doing very well for itself and that another subsidiary is taking life pretty easy and showing a loss to prove it. What are we going to accomplish by adding the detail behind the investment in the first company to the detail behind the investment in the second? As far as presenting information to shareholders is concerned, it could be like trying to tell a combined story of the lives of Sir Galahad and Don Quixote!

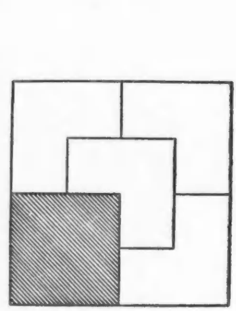
PUZZLE

A train leaves Toronto for Montreal travelling at 55 miles an hour, and at the same time another train leaves Montreal for Toronto travelling at 65 miles an hour. The distance between the two cities is 360 miles.

A housefly travels 100 miles an hour. It starts out with the train leaving Toronto for Montreal, travels on ahead of it until it meets the train from Montreal on the way to Toronto, then reverses direction and travels back until it meets the train from Toronto, then reverses direction again until it meets the train from Montreal, and so on.

How many miles does the fly travel by the time the trains meet?

SOLUTION TO LAST MONTH'S PUZZLE



PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect of course the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Intermediate Examination, November 1948

Accounting II, Question 2 (5 marks)

For each of the following cases state whether the proposed refinancing would be financially desirable and submit schedules to support your conclusion:

(a) Sun Company Limited, on 31st December 1937, issued $500,000 of 20 year 6% bonds at 82, callable at par, and has been amortising the discount in equal annual amounts. As of 31st December 1947, it is proposed to substitute $500,000 of 10 year bonds at 4%, to be sold at par. Refinancing expenses will amount to $15,000.

(b) On 1st January 1937, the Dry Company Limited issued at par $1,000,000 of 5% bonds due 1957, callable at any time prior to that date at 105. As of 1st January 1947, it is proposed to refund by means of 30 year 4% bonds, to be sold at par to cover total cost of refunding. Refinancing expenses will amount to $91,000.

(Note—Ignore compound interest).

A SOLUTION

(a) **Sun Company**

	Annual Costs	
	Present Scheme	*Proposed Plan*
Discount $\frac{90,000}{20}$	4,500	0
Interest	30,000	20,000
Refinancing Expense $\frac{45,000 + 15,000}{10}$		6,000
Total Annual Expense	34,500	26,000

Therefore the proposed plan would be financially desirable.

(b) **Dry Company**

New issue:

Par value of old bonds:	$1,000,000
Call premium = 5 × 10,000	50,000
Refinancing expense	91,000
Total par value of new issue	$1,141,000

Annual Costs:

Present plan = Interest 5/100 × 1,000,000	$ 50,000
Proposed plan = Interest 4/100 × 1,141,000	$ 45,640
plus amortization $\frac{50,000 + 91,000}{30}$	4,700
	$ 50,340

Therefore the proposed plan would not be financially desirable.

PROBLEM 2

Intermediate Examination, November 1948

Accounting II, Question 3 (15 marks)

O. Faith and I. Hope entered partnership on 1st January 1944, and commenced operations as a small manufacturing concern.

At 31st December 1947, it is decided to dissolve the partnership and the auditor has

been asked to determine the amount in the capital accounts of each partner as at this date.

The following information is taken from the partnership agreement:

1. Original capital invested: O. Faith $7,000
   I. Hope 5,500
2. Interest on capital allowed at 3% on balances as at the beginning of the year, this amount to be credited to the partners' capital accounts.
3. O. Faith is to receive a monthly salary of $150 and this salary shall be charged against profits before charging interest on capital. If the profits before interest on capital but after provision for salary do not exceed 7% of the total capital as at the beginning of the year, then O. Faith's monthly salary shall be reduced to $100 the following year, and remain at this figure until the yearly profits advance to more than 7%, when the salary shall return to $150, commencing the year following the one showing the increase in profits.
4. If in any one year profits before interest on capital but after provision for salary exceed 10% of the total capital as at the beginning of the year, O. Faith shall receive a bonus calculated as follows:
   30% on excess earnings up to $1,750.
   25% on any further earnings.
5. Any profits, after provision for O. Faith's salary and any bonus applicable, and interest on partner's capital, shall be divided equally between the partners and credited to their accounts.
6. O. Faith has withdrawn only his salary and bonus during the 5 years.
7. I. Hope withdrew $500 each year up to and including 1945, and $2,000 in each of 1946 and 1947.
8. Profits for the last four years before deducting salary, interest or bonus are found to be:

1944	$2,500
1945	3,000
1946	5,550
1947	6,250

Required:

(a) Schedule showing the computation of the profits to be distributed between the partners at the end of each year.

(b) Capital accounts for each of the partners covering the four year period.

A SOLUTION

(a) O. FAITH AND I. HOPE — PROFITS FOR DISTRIBUTION

	As at 31st December			
	1944	1945	1946	1947
Profits before deductions	$2,500	$3,000	$5,550	$6,250
Less:				
Salary—O. Faith	$1,800	$1,200	$1,800	$1,800
Bonus—O. Faith	—	159	679	827
Interest on Capital @ 3%	375	381	415	447
Profits for distribution	$ 325	$1,260	$2,656	$3,176
O. Faith	$ 163	$ 630	$1,328	$1,588
I. Hope	162	630	1,328	1,588

(b) O. FAITH AND I. HOPE — CAPITAL ACCOUNTS

		O. Faith		I. Hope	
1/1/44	Capital Invested		$7,000		$5,500
	Add: Interest on Capital	$ 210		$ 165	
	Share of Profits	163	373	162	327
			7,373		5,827
	Less: Drawings				500
1/1/45	Capital Invested		7,373		5,327
	Add: Interest on Capital	221		160	
	Share of Profits	630	851	630	790
			8,224		6,117
	Less: Drawings				500
1/1/46	Capital Invested		8,224		5,617
	Add: Interest on Capital	247		168	
	Share of Profits	1,328	1,575	1,328	1,496
			9,799		7,113
	Less: Drawings				2,000
1/1/47	Capital Invested		9,799		5,113
	Add: Interest on Capital	294		153	
	Share of Profits	1,588	1,882	1,588	1,741
			11,681		6,854
	Less: Drawings				2,000
	Capital as at 31st December 1947		11,681		4,854
	Calculation of bonus:	1944	1945	1946	1947
	Profits less salary	700	1,800	3,750	4,450
	10% of Capital	1,250	1,270	1,384	1,491
	Excess	0	530	2,366	2,959
	30% on		530	1,750	1,750
	25% on			616	1,209

Editor's Note: Because Faith's drawings are the same as his salary and bonus, the above statement omits a charge for his drawings and a credit for his salary and bonus allowance. An alternative presentation would be to show his salary and bonus as credits to his capital and to deduct his drawings.

PROBLEM 3

Final Examination, November 1948

Accounting III, Question 3 (20 marks)

A. J. Jones, who is married and has 2 children (John age 15, at home and Peter age 19, at university), has an opportunity to invest in the partnership of A, B & C. A is retiring from the partnership and has offered to sell his interest in the firm to Mr. Jones for $30,000. Mr. Jones would then receive A's share of the profits, after A's salary and interest on partners' capital, which are presently divided in the ratio A, 2; B, 1; C, 2;

and he would also take over A's executive position in the business which carries with it an annual salary of $4,000. The partnership agreement provides for 5% interest per annum on partners' capital investments.

Mr. Jones has been handed the following statements:

A, B & C
BALANCE SHEET
As at 31st December 1947

ASSETS

Cash		$ 500	
Bank		2,700	
Accounts receivable	$ 9,000		
Less: reserve	2,000		
		7,000	
Inventories		11,500	
			$ 21,700
Investments in government bonds			13,300
Fixed assets, less depreciation			100,000
			$135,000

LIABILITIES

Accounts payable		$ 10,000
5% Mortgage		40,000
Capital: A	$ 20,000	
B	25,000	
C	40,000	
		85,000
		$135,000

A, B & C
OPERATING FIGURES

	For Years ended 31st December		
	1945	1946	1947
Sales	$48,000	$62,000	$78,650
Less: Cost of sales	28,000	30,000	44,000
Gross profit	$20,000	$32,000	$34,650
Expenses:			
Selling	$ 4,500	$ 8,700	$10,000
General and administrative (not including A's salary)	5,000	5,500	5,900
Mortgage interest	2,000	2,000	2,000

There seems to be no reason to believe that A's retirement will have any effect upon the profits of the business. Mr. Jones considers the prospects of the firm are satisfactory and that profits can probably be maintained at the same level as they were in 1947.

Before deciding to invest in this firm Mr. Jones looked around and discovered he could buy from X 3,000 shares of Class B common shares of the XYZ Company Limited, at $10 each. This company is in the same line of business as A, B & C, and Mr. Jones further learns that he could take over the executive position with the company presently held by X, at an annual salary of $6,000.

The following are the statements of the XYZ Company Limited:

XYZ COMPANY LIMITED
BALANCE SHEET
As at 31st December 1947

ASSETS

Cash		$ 500	
Bank		3,200	
Accounts receivable	$ 26,000		
Less: reserve	1,200		
		24,800	
Inventories		30,100	
			$ 58,600
Fixed assets, less depreciation			66,000
Goodwill			10,000
			$134,600

LIABILITIES

Accounts payable		$ 15,000
Capital—Class A common, 5% cumulative (authorized 5,000 shares at $100)	$ 50,000	
Class B common (authorized 7,500 shares at $10)	50,000	
		$100,000
Surplus		19,600
		134,600

XYZ COMPANY LIMITED
OPERATING FIGURES

	For Years ended 31st December		
	1945	1946	1947
Sales	$68,000	$74,000	$81,000
Less: cost of sales	44,000	43,500	50,100
Gross profit	$24,000	$30,500	$30,900
Expenses:			
Selling	$ 6,300	$ 7,100	$ 9,850
General and administrative	9,800	10,200	12,000
Financial	1,400	1,500	1,600

Further enquiry shows that dividends have been declared regularly and that in 1947, the Class B shareholders received a dividend of 8%. Mr. Jones feels the profits could be increased by an advertising campaign and a more aggressive sales policy.

Mr. Jones has asked advice as to the advisability of purchasing A's interest in the partnership A, B & C, as opposed to the alternative investment in XYZ Company Limited.

Required:

Explain the various considerations, including Dominion but not Provincial income taxes, which Mr. Jones should take into account in arriving at his decision.

A SOLUTION

Jones is married and has 2 dependents (one under Family Allowance provision and one at University) ∴ his tax exemption is $1,900 at 1947 rates.

1. His share of the 1947 profits in the Partnership of A, B & C would have been:

2/5 of net profit after interest on captial and his own salary, or 2/5 x $8,500, which is	$3,400
+ Annual salary	4,000
+ Interest on capital, 5% of $20,000	1,000
Total Income	8,400

2. His income for 1947 from the XYZ Company Ltd., would have been:

8% dividend on investment of $30,000	$2,400
+ annual salary	6,000
Total income	8,400

Surtax on Investment Income of 2400-1800 or 600 @ 4% = $24.

3. On the basis of 1947 operations, the total income from the partnership would be $8,400, whereas Mr. Jones' share of the company's income would be only $7,629*, although the actual return was $8,400.

Assuming 1948 levels of income taxes, the company profits would have to increase to at least $9,285.71 before his share of the profits after taxes would be equal to his portion of the partnership income after taxes. In view of Mr. Jones' estimate of future prospects this may be possible. Jones should keep in mind the possibility of legislation similar to Part XVIII of the Income War Tax Act, enabling payment of surplus to shareholders when tax rates may be lower.

4. In the case of the company, the investment risk is carried by the company; in the case of the partnership, any loss is borne by the partners directly.

5. In the partnership, there is unlimited personal liability; in the company his liability is limited to his share investment.

6. In the partnership he is only a partner; in the company, by virtue of the fact that he will be owning 3000 of the 5000 Class B. shares issued, he will be in control.

7. If he buys A's share of the partnership, his $30,000 will buy only $20,000 of the total of $85,000 partnership capital, whereas, in the company, his $30,000 purchases a share in the equity of the company with a book value of $41,760. (Jones' share 3/5 of (equity of 119,600—Class A $50,000))

8. On dividend income from the company, Jones has to pay a surtax (present rates 4%) on investment income over $1,800 per year, so that his income from the company would have to be slightly more than from the partnership.

9. Out of each $1.00 increase in partnership income Jones would receive 40c assuming no change in the capital accounts of the partners; out of each $1.00 increase in company profit Jones would be eligible to receive 3/5 of $1.00 — 30% = 3/5 × 70c = 42c assuming no change in Jones' stock holdings.

10. In the case of the company, there is the possibility of setting up a pension fund which would be allowed as an expense to the company and as a deduction from Jones' income; this advantage could not be obtained through the partnership.

11. For succession duty purposes, it would be easier to arrive at a value of Jones' interest in the company than in the partnership.

12. If he desires to liquidate his investment, this can be done more easily through the sale of shares in the company than by the sale of his interest in the partnership.

13. There is the possibility of declining tax rates in the future, and the withdrawal of profits in the form of dividends can be arranged as the tax rates vary.

14. Because of the apparent future prospects for increased profits of the company and the fact that for $30,000 he would take over A's capital equity of $20,000 in the partner-

ship, it would appear that Jones would be well advised to purchase the stock of the XYZ Company Ltd., and take over the executive position held by X rather than invest in the partnership and become the managing partner.

* **Editor's note:**

1947 profits XYZ Co. Ltd. before taxes	$7,450
1947 profits XYZ Co. Ltd. after taxes (70%)	5,215
Dividend to Class A shares: 500 shares @ $5	2,500
Available for Class B shares	2,715
Jones' share: 3/5 of $2,715	1,629
Jones' salary	6,000
Jones' share of company's income	$7,629

PROBLEM 4

Final Examination, November 1948

Accounting III, Question 4 (10 marks)

The Holding Company Limited, a Dominion Company, derives its income wholly from dividends received from its subsidiaries. The following figures are taken from the financial statements of the five subsidiaries for the years 1945 to 1947 inclusive:

		Net profit	Deduct income and excess profits taxes	Deduct dividends declared and paid	Balance to surplus
Company 1	1945	$ 5,000*	$...........	$...........	$ 5,000*
	1946	4,500	....	....	4,500
	1947	27,500*	....	....	27,500*
Company 2	1945	114,000	68,500	40,000	5,500
	1946	137,000	67,000	50,000	20,000
	1947	8,200*	....	10,000	18,200*
Company 3	1945	7,000	....	....	7,000
	1946	6,000*	....	....	6,000*
	1947	8,500*	....	....	8,500*
Company 4	1945	193,000	77,200	110,000	5,800
	1946	214,800	71,600	125,000	18,200
	1947	312,000	96,000	125,000	91,000
Company 5	1945	145,000	68,000	30,000	47,000
	1946	180,000	49,800	50,000	80,200
	1947	148,000	47,000	50,000	51,000

**Denotes a loss.*

Other than directors' qualifying shares, which may be diregarded for the purposes of this question, the Holding Company Limited owns 100% of the issued shares of Company 1; 100% of Company 2; 95% of Company 3; 100% of Company 4; 90% of Company 5.

Up to and including 31st December 1944, the Holding Company Limited filed consolidated returns for income tax purposes, but for 1945, 1946 and 1947 separate returns were filed for each company. The directors are considering reverting to consolidated returns. They have asked the opinion of the company's auditors as to the advisability of so doing, and as to any special factors which must be taken into consideration, and have also asked him to estimate any probable saving in tax that might result from such action.

Required:

What considerations should the auditor take into account in arriving at his opinion?

Note: Candidates are reminded that in computing future profits the income tax law as at 31st December 1947 should be deemed to apply.

A SOLUTION

1. In order to file consolidated returns, the subsidiary companies must be wholly owned —only 1, 2 and 4 may be consoldiated.

2. With the carry forward and carry back provisions, the only advantage in consolidating is where one company operates consistently at a loss, since if this is not the case, the 2% additional tax on consolidated returns offsets any advantage which might otherwise accrue.

3. In any event, the company must elect to file consolidated returns prior to the commencement of the fiscal year for which the provision is to become applicable, and once this has been done, the decision cannot be revoked for five years. Therefore, the Holding Company Limited must continue to file separate returns for each company for the years 1948 and 1949.

The auditor is not justified in forecasting probable savings in this case, since they are not eligible to file consolidated returns until 1950.

PROBLEM 5

Final Examination, November 1948

Accounting III, Question 6 (5 marks)

(a) C, a resident of New York, is employed during 1947 by a U.S. Company at a monthly salary of $1,000. C is married and has 4 children, ages 2, 4, 7 and 11. During 1947 he received interest on bond and bank balances of $1,100 and made charitable donations of $900. His 1947 tax to the U.S. Government amounted to $2,265.

During 1947 C spent five months in Canada on company business and was reimbursed for his living and travelling expenses during this time amounting to $2,100, in addition to his regular salary.

Required:

Does C pay income tax in Canada? If so, how much? If not, why not?

(b) D, a resident of New York, is employed during 1947 by a U.S. Company at a monthly salary of $600. D is married and has 2 children, ages 6 and 10. During 1947 he received interest income of $540 and made charitable donations of $200. His 1947 tax paid to the U.S. Government was $1,089.75.

During 1947 he was given two months' leave of absence to come to Canada in order to do special work for a Canadian company. For this work he is paid $1,000 per month and reimbursed for his living and travelling expenses of $400 per month by the Canadian company.

Required:

Does D pay income tax in Canada? If so, how much? If not, why not?

A SOLUTION

(a) C does not pay income tax in Canada since by the Tax Convention he was an employee of a U.S. Company, was in Canada not more than 183 days and the compensation he received was not more than $5,000.

(b) According to the Tax Convention, a U.S. resident who is employed in Canada by a Canadian Company for more than 90 days and receives income in excess of $1,500 is taxable in Canada on the income earned in Canada.

D does not pay tax, however, while his income is in excess of $1,500., his marital and dependents' exemptions amount to ($1,500 + $300 + $300) $2,100. Exemptions for children are $300 since the children are not eligible for Family Allowances.

PROBLEM 6

Final Examination, November 1948

Accounting III, Question 7 (15 marks)

YIPPY ZIPPY FASTENER COMPANY LIMITED

STATEMENT OF EARNINGS

For Years Ended 31st December

	1944	1945	1946	1947
Sales	$985,000	$950,000	$945,000	$1,200,000
Cost of goods sold	542,000	580,000	587,000	700,000
Gross margin on sales	$443,000	$370,000	$358,000	$ 500,000
Less:				
Selling expenses	$161,000	$162,600	$162,500	$ 190,000
Administrative and general expense	163,000	163,750	164,600	195,000
Donations	10,000	10,000	12,000	12,000
Interest on bonds	6,000	6,000	6,000	6,000
Amortization of bond discount	150	150	150	150
Loss on disposal of investments				500
Loss on disposal of fixed assets		100		
Loss on sale of automobile		450		
†Guarantees expense	9,850	9,500	9,450	12,000
Premium—life insurance policy on president	450	450	450	450
Dividends paid	10,000	10,000		10,000
Directors' fees and expenses	7,000	7,600	7,850	8,000
Depreciation	9,400	10,000	10,000	10,000
Operating profit	$ 66,150	$ 10,600*	$ 15,000*	$ 55,900
Add:				
Dividends from Canadian subsidiaries	1,500	1,500	1,200	2,500
Dividends from other Canadian companies	250	350	500	
Dividends from foreign companies	1,000	1,000	500	1,000
Profit on sale of fixed assets			610	
Profit on sale of automobile	600			
Increase to surplus for year	$ 69,500	$ 7,750*	$ 12,190*	$ 59,400

****Indicates a loss.***

†Analysis of guarantees expense				
Payments in respect of guarantees	$ 10,300	$ 3,100	$ 14,500	$ 11,000
Less: charged to reserve	450		5,050	
Add: credited to reserve		6,400		1,000
Charge to expense for year	$ 9,850	$ 9,500	$ 9,450	$ 12,000

Required:

Prepare a statement showing the final assessable income under the Income War Tax Act of the Yippy Zippy Fastener Company Limited in respect of each of the years 1944 to 1947 inclusive.

A SOLUTION

YIPPY ZIPPY FASTENER CO. LTD.

Statement of Taxable Income

1944 to 1947 inclusive

	1944	1945	1946	1947
Increase to surplus as per statement	$ 69,500	$ 7,750*	$ 12,190*	$ 59,400
Add—Items not allowable				
Dividends	10,000	10,000		10,000
Premium on life insurance	450	450	450	450
Amortization of bond discount	150	150	150	150
Loss on investments and fixed assets		100		500
Guarantees to adjust to payments		6,400		1,000
Donations—see below	10,000	10,000	12,000	12,000
	$ 90,100	$ 19,350	$ 410	$ 83,500
Deduct—Items not taxable				
Guarantees — to adjust payments	450		5,050	
Dividends from Can. subsidiaries	1,500	1,500	1,200	2,500
Dividends from other Can. companies	250	350	500	
Profit on fixed assets			610	
	$ 2,200	$ 1,850	$ 7,360	$ 2,500
	$ 87,900	$ 17,500	$ 6,950*	$ 81,000
Less — Donations allowable	4,395	875		4,050
	$ 83,505	$ 16,625		$ 76,950
Assuming no losses in 1942 and 1943 for purposes of 5(1)(p) and assume other items in statement are allowable as set out, assessable income bearing tax at rates applicable to year as set out is	$ 83,505	$ 16,625		
Less: adjustment the following year in respect to 1946 loss		6,950		
		†$ 9,675		$ 76,950

* *denotes red figures*

† *Note — Tax Department takes the stand that loss must be determined by including non-taxable revenues.*

PUBLICATIONS

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THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS